Ju 11.7/2:1986-363

COMPLETED
20

MF211

T. C. Memo. 1986-363

ORIGINAL

UNITED STATES TAX COURT

UNIVERSAL RACQUETBALL ROCKVILLE CENTRE CORPORATION, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 30265-83. Filed August 11, 1986.

John A. Matthews, Jr., for the petitioner.

Laurence D. Ziegler, for the respondent.

MEMORANDUM OPINION

TANNENWALD, Judge: Respondent determined a deficiency of $24,696 in petitioner's Federal income tax for the taxable year ending June 30, 1980. The issue for decision is whether petitioner is entitled to an interest deduction of $56,551 based on $377,040 of long-term notes or whether such deduction should

BEST COPY AVAILABLE

be disallowed under sections 163[1] and 385 since the advances did not constitute debt of petitioner but were contributions to its capital.

This case was submitted fully stipulated under Rule 122. This reference incorporates herein the stipulation of facts and attached exhibits.

Petitioner maintained its principal place of business in Rockville Centre, New York at the time the petition herein was filed. Petitioner timely filed its U.S. Corporation Income Tax Return for the taxable year ending June 30, 1980, with the Internal Revenue Service Center, Holtsville, New York. During the year in issue, petitioner was on the accrual basis of accounting.

Petitioner was incorporated on March 2, 1978 to conduct and operate a racquetball facility. At the time of its incorporation, petitioner issued 94.99 shares of capital stock which were owned as follows:

---

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

BEST COPY AVAILABLE

Shareholder	Number of Shares
William P. Farrell, Jr.	29.57
James O'Neill	16.00
James R. Farrell	3.00
Olympia Sports Products, Inc.	3.57
Walter Gatz	19.00
Peter F. Yaman	3.00
Vincent Zuaro	5.00
Ronald P. McNavich	1.00
B. Lawson Greenhalgh, Jr.	2.00
Alan M. Butler	1.43
Jerome E. Seckler	1.43
Peter J. Cimino	2.85
William S. Swartz	7.14
Total Shares	94.99

William Farrell, Jr. was the sole shareholder of Olympia Sports Products, Inc; James Farrell is the brother of William Farrell, Jr. and a brother-in-law of James O'Neill. Of the original 94.99 shares issued by petitioner, 56 shares were sold to the shareholders for $1,750 each (total price $97,990[2]) and the balance of 38.99 shares (40 percent) was given for no consideration to William Farrell, Jr., James O'Neill, Walter Gatz, and James Farrell.

---

2 Although the $1,750 price per share would indicate a total purchase price of $98,000, the parties have stipulated, and the financial statements and the balance sheet on petitioner's tax return list, such amount as $97,990. The $10 discrepancy is unexplained and has no affect on our decision herein.

BEST COPY AVAILABLE

On July 1, 1978, the shareholders named below[3] entered into transactions with petitioner whereby monies totaling $377,040 were given to petitioner in return for long-term promissory notes.

Shareholder	Amount
William Farrell, Jr.	$ 24,860
Walter Gatz	98,000
James O'Neill	92,000
William Swartz	42,860
Peter Yaman	18,000
Vincent Zuaro	30,000
James Farrell	10,000
Alan Butler	8,570
Peter Cimino	17,180
B. Lawson Greenhalgh, Jr.	12,000
Jerome Seckler	8,570
Ronald McNavich	6,000
Carl Lehmann	9,000
Total	$377,040

3

There is some confusion in the record as to whether Carl Lehmann was in fact a shareholder as well as a noteholder. Although the parties did not stipulate that he was an owner of petitioner's stock at the time of petitioner's incorporation on March 2, 1978 (see pp. 2-3, supra), he was listed in the stipulation as a shareholder/noteholder on July 1, 1978, and as a shareholder/guarantor in 1979. Since it is entirely plausible that Mr. Lehmann could have acquired a stock interest in petitioner after incorporation but before the issuance of the notes or the signing of the guarantee agreement, and since petitioner has offered no evidence to refute such an assumption on our part, we conclude that Mr. Lehmann was a shareholder of petitioner at the time the notes were issued. We note, however, that our decision herein is not affected by this conclusion.

BEST COPY AVAILABLE

These notes were all due on June 30, 1987, with interest payable annually at 12 percent, and were classified by petitioner on its financial statements as Long Term Liabilities--Shareholders.[4] They were unsecured. It was agreed that interest due on the notes would be paid only if there were sufficient funds available to pay the interest due on all of the notes.

On July 1, 1979, the original notes were replaced with new notes, the only change being in the interest rate, which was increased from 12 percent to 15 percent.

Petitioner sought these funds from its shareholders because, after obtaining a first mortgage on its real estate and bank financing in the form of equipment leases, petitioner was unable to secure additional funds from conventional sources such as banks, since such sources were either not interested in supplying the monies or the costs were excessive. The $377,040 petitioner received from its shareholders was used to pay for the construction costs and initial working capital of petitioner.

No interest payments have been made by petitioner to the shareholders with respect to either the notes that were given originally on July 1, 1978, or the replacement notes issued on July 1, 1979.

4

Although the parties have consistently used the figure of $377,040, the financial statements and the balance sheet on petitioner's tax return list the amount of such liabilities as $377,010; the $30 discrepancy is unexplained.

BEST COPY AVAILABLE

The notes to the financial statements of petitioner for the fiscal year ending June 30, 1980 (the year before the Court) contain the following statement:

> Notes payable shareholders (long term) are payable on demand with interest at 15% per annum, payable semi-annually. At June 30, 1980 interest had been accrued but not paid on these shareholders notes. It is not expected that these loans will be repaid in the near future. [Emphasis added.]

Subsequent financial statements for the fiscal years ending June 30, 1981, June 30, 1982 and June 30, 1983, eliminated the "emphasis added" material and substituted "on June 30, 1987" for the words "on demand." The notes to the financial statements ending June 30, 1984 used this same language and added the sentence, "Since July 1, 1983 the loans do not accrue interest."

Petitioner has not created any reserve or sinking fund to pay the principal of the long-term notes or the interest due thereon.

Additional short-term unsecured loans totalling $392,941 were made by various shareholders and third parties to petitioner during the period July 1978 through June 1983. Petitioner has repaid $282,441 of these loans. Of these total amounts, $284,341 in loans and $184,341 in repayments were in respect of funds advanced by petitioner's shareholders. Interest payments on the short-term loans were paid when due to both the shareholders and the third parties.

BEST COPY AVAILABLE

On January 4, 1979, petitioner entered into a contract with Macrolease International Corporation ("Macrolease") whereby various items of equipment were leased to petitioner to be used in its racquetball facility, and petitioner was given an option to purchase the equipment at the end of the lease for the payment of one dollar. The total cost of the equipment was $133,749.84 of which $7,961.30 was paid in advance and the balance was evidenced by a promissory note requiring 79 payments of $1,592.26. Petitioner's shareholders guaranteed the payment of this note, as well as the payment of any rents or installments when due of any existing or future indebtedness and liability from petitioner to Macrolease. Macrolease was given a security interest in the equipment which was subject to the lease, and pursuant to an agreement entered into by petitioner and all of its shareholders on January 22, 1979, petitioner's obligation to its shareholders for the interest and principal due on the $377,040 of long-term notes was subordinated to petitioner's obligation to pay Macrolease in full any and all indebtedness then existing or thereafter created.

Petitioner purchased in 1978 the property on which its racquetball facility is located for a total price of $540,000, of which $120,000 was paid in cash and the balance by a mortgage of $420,000 payable over 30 years. The construction cost of the racquetball facility was $1,236,673 as of June 30, 1980, and the machinery and equipment as of that date cost $333,481.

BEST COPY AVAILABLE

The debt to equity ratios of petitioner as of June 30, 1979 were 5.18:1 as an outside ratio and 3.27:1 as an inside ratio, to be calculated as per Proposed Regulation section 1.385-6(g) and (h),[5] which has since been withdrawn by respondent (see p. 11, infra). Petitioner's after tax income (loss) for the fiscal years ending June 30, 1979 through June 30, 1984 was as follows:

Fiscal Years Ending	Net Income (Loss)
6/30/79	$ 91,361
6/30/80	74,817
6/30/81	94,598
6/30/82	94,322
6/30/83	(67,785)
6/30/84	7,412

The issue for decision is whether the $377,040 advanced by the shareholders to petitioner in the form of long-term promissory notes constituted an actual indebtedness to the corporation, entitling petitioner to deduct under section 163(a) $56,551 in interest which accrued on these notes during the taxable year ending June 30, 1980. Respondent argues that this deduction should be disallowed because the notes did not constitute bona fide indebtedness, but were instead simply contributions to petitioner's capital. For the reasons hereinafter set forth, we agree with respondent.

---

5 Pursuant to the Proposed Regulation, a corporation's outside ratio is the ratio of its liabilities (excluding trade accounts payable, accrued operating expenses and taxes, and other similar items) to its stockholders' equity. A corporation's inside ratio is determined in the same manner, but excludes liabilities to independent creditors.

BEST COPY AVAILABLE

In determining whether monies paid to a corporation by its stockholders constitute debt or equity, we focus not on the form of the transaction but on its substance. Gregory v. Helvering, 293 U.S. 465 (1935). As the Second Circuit Court of Appeals noted in Gilbert v. Commissioner, 248 F.2d 399, 404 (2d Cir. 1957), remanding a Memorandum Opinion of this Court, "not every advance cast in the form of a loan gives rise to an 'indebtedness' which will justify a tax deduction." It must be proven by petitioner (Matthiessen v. Commissioner, 194 F.2d 659, 661 (2d Cir. 1952), affg. 16 T.C. 781 (1951); Rule 142(a)), that the "loan" is not "so risky that it can properly be regarded only as venture capital." Gilbert v. Commissioner, 248 F.2d at 407. Or to put it another way, an advance can be found to be a "contribution to risk capital" rather than merely a "risky loan". Motel Company v. Commissioner, 340 F.2d 445, 446 (2d Cir. 1965), affg. a Memorandum Opinion of this Court. Moreover, when dealing with instruments such as those in the instant case which

> are entirely conventional in form and contain no ambiguity on their face * * * the problem is not one of ascertaining "intent," since the parties have objectively manifested their intent. It is a problem of whether the intent and acts of these parties should be disregarded in characterizing the transaction for federal tax purposes. [Kraft Foods Co. v. Commissioner, 232 F.2d 118, 123 (2d Cir. 1956), revg. on other grounds 21 T.C. 513 (1954). Fn. ref. omitted.]

Despite a plethora of cases, no bright line test has emerged to aid us in making such a determination. To the contrary, our decision "must be made in the light of all the facts of the particular case." Gilbert v. Commissioner, 262 F.2d 512, 514 (2d

BEST COPY AVAILABLE

Cir. 1959), affg. a Memorandum Opinion of this Court. Furthermore, "[t]here is no one characteristic * * * which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts." John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946).

In examining the factors which bear on whether the notes issued by petitioner are debt or equity, we look initially to section 385, which was added to the Internal Revenue Code as part of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 613, and authorizes the Secretary of the Treasury to prescribe "regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated * * * as stock or indebtedness." Section 385(a). Section 385(b) requires that these regulations set forth factors which are to be used in making such a determination, which may include but are not limited to:

> (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
>
> (2) whether there is subordination to or preference over any indebtedness of the corporation,
>
> (3) the ratio of debt to equity of the corporation,
>
> (4) whether there is convertibility into the stock of the corporation, and
>
> (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

BEST COPY AVAILABLE

Unfortunately, although regulations were finally proposed in 1980 and adopted later that same year (T.D. 7747, 1981-1 C.B. 141), they never became effective; they were eventually withdrawn in 1983 (T.D. 7920, 1983-2 C.B. 69), and have yet to be resurrected.[6] Thus, while section 385 is still helpful as a general guide in our deliberations, resolution of the issue herein requires us to examine the myriad of factors, see Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980), which the courts have considered in dealing with the debt versus equity question. Since certain factors may be important in one set of circumstances but not in another, we will limit our observations to the specific facts of this case which we consider to be of particular significance in making our determination that the "loans" were in fact contributions to petitioner's capital. In so doing, we look for guidance primarily to the opinions of the Court of Appeals for the Second Circuit, to which an appeal in this case would lie. See Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 376 (1973).[7]

6

We note that the final regulations, as first adopted, were only to apply to instruments created after April 30, 1981. Thus, even if they had not been withdrawn, the regulations would not have impacted upon our decision herein. Similarly, since the proposed regulations were not even published until March 24, 1980, petitioner cannot argue that it relied upon them at the time it was being initially capitalized.

7

We recognize, that, because of the variations in the fact pattern in this case from those involved in the cases to which we shall point, we are not inexorably bound to reach a given result

(footnote continued)

BEST COPY AVAILABLE

We note at the outset that certain factors do point in petitioner's direction. Thus, the promissory notes bear all the formal indicia of debt instruments. However, the issue herein is whether the surrounding circumstances support the conclusion that there was an indebtedness in substance as well as form. See Ambassador Apartments, Inc. v. Commissioner, 50 T.C. 236, 244 (1968), affd. 406 F.2d 288 (2d Cir. 1969). We also recognize that the absence of proportionality between the shareholders' interests in petitioner's stock and their ownership of petitioner's "debt" obligations is a factor often considered by the courts as indicating a debt as opposed to equity investment. Compare Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir. 1972), with Slappey Drive Industrial Park v. United States, 561 F.2d 572, 583-584 (5th Cir. 1977). However, in the same way that "[w]here the creditors as stockholders have a proprietary interest in proportion to their loans, this may subject the transaction to 'close scrutiny' but does not necessarily preclude treating the transaction as a valid indebtedness," Tomlinson v. 1661 Corporation, 377 F.2d 291, 297 (5th Cir. 1967), the corollary is also necessarily true, namely, that the absence of such identity of ownership is not dispositive of a finding that the transaction constitutes a valid loan but is only one of many factors to be considered in making such a determination.

(footnote continued from previous page)
under the so-called Golsen doctrine. See Golsen v. Commissioner, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

BEST COPY AVAILABLE

Moreover, we note that only stockholders were noteholders herein and that, at least with respect to some of the substantial shareholders/noteholders, there were family relationships and, in one instance, ownership of petitioner's stock by one individual and also by his wholly-owned corporation. See Slappey Drive Industrial Park v. United States, supra at 584. Similarly, the added fact that the notes did not provide for convertibility to stock does not in and of itself prove that they were debt instruments. Thus, although the foregoing factors are suggestive of the existence of a bona fide debt "[t]he object of the inquiry is not [simply] to count factors, but to evaluate them." Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969). We now turn to an analysis of the factors which point to a conclusion that the notes represented equity rather than debt.

The first factor is whether petitioner "could have obtained debt financing on similar terms from an independent creditor." Litton Business Systems, Inc. v. Commissioner, supra at 379; see also Nassau Lens Co. v. Commissioner, 308 F.2d 39, 47 (2d Cir. 1962), remanding on other grounds 35 T.C. 268 (1960); Gilbert v. Commissioner, 248 F.2d at 406. Petitioner has admitted that it was the inability to secure similar loans from outside lenders that led it to seek financing from its shareholders in the first place. Petitioner's difficulty in obtaining such outside financing only serves to underscore the inherent defects in the instant transactions which militate against the conclusion that,

BEST COPY AVAILABLE

as a matter of "substantial economic reality" (see Gilbert v. Commissioner, 262 F.2d at 514), the notes constitute bona fide loans entered into as part of a legitimate debtor-creditor relationship.

Even absent petitioner's admission, it is highly unlikely that a disinterested lender would have made initial, unsecured loans of almost $400,000 in order to provide petitioner with the working capital necessary to start up its business. See Matthiessen v. Commissioner, 16 T.C. 781, 786 (1951), affd. 194 F.2d 659 (2d Cir. 1952). However, even assuming arguendo that petitioner could have secured such start-up capital from an outside creditor, it is doubtful, given the inherent risk of any new venture, that such a creditor would have also agreed to (1) no security for the loans; (2) subordinate the loans to the present and future obligations of another outside creditor; (3) forego the current payment of interest unless there were sufficient funds available to pay all of the noteholders; and (4) not require that petitioner set up some type of sinking or reserve fund to provide for the orderly accumulation of funds over the years to pay back the loans when they came due.

The courts have often looked at the lack of security as a factor to be considered in determining whether a loan should be recognized as such for tax purposes. E.g., In re Lane, 742 F.2d 1311, 1317 (11th Cir. 1984); Tyler v. Tomlinson, supra at 849; Gilbert v. Commissioner, 262 F.2d at 513. Similarly, the

BEST COPY AVAILABLE

subordination of a loan to another creditor is a factor to be looked at in determining whether such loan lacks economic reality. Nassau Lens Co. v. Commissioner, supra at 47; Charter Wire, Inc. v. United States, 309 F.2d 878, 881 (7th Cir. 1962). We recognize that "[s]ubordination to general creditors is not necessarily indicative of a stock interest," Kraft Foods Co. v. Commissioner, 232 F.2d at 125, and that petitioner correctly points out that the notes were only subordinated to the Macrolease leases, and not to all general creditors. However, the Macrolease subordination agreement subordinated the shareholders' interests not only to current fixed obligations, but also to all future, and as yet undetermined and potentially unlimited, debt liability of petitioner to Macrolease. We are hard pressed to think of an outside creditor who, given the inherent risk in the start-up of petitioner's business and the lack of any collateral to secure the loans, would advance such large sums of money subject to such an open-ended agreement. Indeed, Macrolease still felt it necessary to go even further and secure personal guarantees from each of the shareholders despite the subordination agreement and a security interest in the leased equipment. In this connection, we reject petitioner's argument that the presence of the guarantees made the subordination undertaking meaningless. The subordination agreement conferred important direct rights on Macrolease with respect to

BEST COPY AVAILABLE

petitioner's assets in the event of petitioner's financial difficulty, without the necessity of making separate claims against each shareholder/noteholder under the guarantees.

We find it equally hard to conceive of an outside lender who would agree not to be paid his interest when due unless there were sufficient funds at such time to pay each and every noteholder. Such an agreement points towards an equity investment in which stockholders receive dividends, which are directly dependent on the success of the business venture. Moreover, we think that, under all the circumstances herein, an outside lender would have required that a sinking fund be established as an assurance that funds would be available to repay the loans when due. Consequently, the absence of such a provision, in respect of the repayment of the notes herein, is another factor which argues against petitioner's claim that a true debtor-creditor relationship existed between it and the shareholders/noteholders. In re Lane, supra at 1317; United States v. Snyder Brothers Co., 367 F.2d 980, 984 (5th Cir. 1966); Charter Wire, Inc. v. United States, supra at 881; National Farmers Union Service Corp. v. United States, an unreported case (D. Colo. 1967, 19 AFTR 2d 67-437, 67-1 USTC par. 9234), affd. 400 F.2d 483 (10th Cir. 1968).

BEST COPY AVAILABLE

The next factor is petitioner's failure to make even a single interest payment with respect to the shareholder notes, and the shareholders' passive acceptance of this circumstance. As the Fifth Circuit Court of Appeals has so aptly explained:

> [t]he failure to insist that the corporations pay the interest that the agreements provided underscores the inference; "a true lender is concerned with interest." * * * When a corporate contributor seeks no interest, it becomes abundantly clear that the compensation he seeks is that of an equity interest: a share of the profits or an increase in the value of his shareholdings. * * * [Slappey Drive Industrial Park v. United States, 561 F.2d at 582. Citations omitted.]

See also Texas Farm Bureau v. United States, 725 F.2d 307, 314 (5th Cir. 1984). Petitioner's explanation that the issuance of the new notes with the increased interest rate was to compensate the shareholders for the non-payment of interest in 1979 is not supported by any evidence other than petitioner's own self-serving statements. Furthermore, although only the taxable year ending June 30, 1980 is before us, the fact that no payments were made in any future taxable year establishes a pattern which tends to negate petitioner's explanation. Moreover, in light of the fact that petitioner entered into an additional $392,941 of short-term loans with certain shareholders and outside third parties (the bulk of the loans being from shareholders, see p. 6, supra) from 1978 to 1983 and paid every interest payment when due on these notes (not to mention $282,441 of the principal), we can draw no other conclusion except that the shareholders did not

BEST COPY AVAILABLE

consider the notes at issue herein to be bona fide debt instruments[8] and had no expectation of receiving interest that accrued thereon.

The next factor is to the use to which the funds represented by the notes were put. Petitioner concedes that the funds were used to pay for construction costs and initial working capital, i.e., "funds to start the corporate life." See Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955). Such use of funds has often been viewed by the courts as permitting an inference that they represent risk capital and not debt. Texas Farm Bureau v. United States, supra at 314; Schnitzer v. Commissioner, 13 T.C. 43, 61 (1949), affd. 183 F.2d 70 (9th Cir. 1950).

Finally, we examine petitioner's debt to equity ratio. "Undoubtedly, the debt-equity ratio resulting from a transaction is of great importance in determining whether an ambiguous instrument is a debt or an equity interest." Kraft Foods Co. v. Commissioner, 232 F.2d at 127. Unfortunately, despite numerous decisions which have discussed this issue, no clear cut set of standards or agreed-upon mathematical formula has arisen to determine whether or not a corporation is thinly capitalized for Federal income tax purposes. Rather, the courts have looked to

---

8 The record is devoid of any evidence to the prospect of petitioner's business at the time the notes were issued. Moreover, evidence of record shows that it is unlikely that the notes could have been paid without selling or distributing petitioner's fixed assets thereby terminating petitioner's business. Cf. In re Lane, 742 F.2d 1311, 1317 (11th Cir. 1984).

BEST COPY AVAILABLE

the specific facts and circumstances in each particular case in making such a determination. While, on the one hand, we cannot say that the facts herein show evidence of an extreme situation which would argue against petitioner's position, such as a nominal stock investment and an obviously excessive debt structure, see John Kelley Co. v. Commissioner, 326 U.S. at 526, it is also not apparent from the record that the ratio was so low as to justify in and of itself a finding that petitioner was adequately capitalized. See Kraft Foods Co. v. Commissioner, supra at 127. To the contrary, the ratios stipulated to by the parties as of June 30, 1979 (3.27:1 inside ratio, 5.18:1 outside ratio), by themselves, do not clearly dictate a finding that the note constituted debt or equity. Cf. Charter Wire, Inc. v. United States, 309 F.2d at 880-881; Litton Business Systems, Inc. v. Commissioner, 61 T.C. at 379. Moreover on July 1, 1978, when originally issued, the inside ratio appears to have been 3.85:1 ($377,040 to $97,990) and the outside ratio appears to have been 8.13:1 ($420,000 plus $377,040 to $97,990).[9] Petitioner has offered us no additional evidence as to what acceptable ratios

---

9

In addition to the "loans" represented by the notes, one of the shareholders advanced $100,000 in July 1978 for a period specified by the parties as "short term." If this amount is included in petitioner's liabilities as of July 1, 1978, the ratios become even greater.

BEST COPY AVAILABLE

would be with respect to a start-up business in petitioner's industry, see P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 788 (3d Cir. 1962), affg. a Memorandum Opinion of this Court.[10]

In view of the foregoing, and within the guidelines of the opinions of the Second Circuit Court of Appeals (see p. 11, supra) as augmented by other decided cases, we hold that petitioner has failed to carry its burden of proof that the long-term promissory notes were bona fide debt instruments and that the monies given in exchange for such notes did not constitute contributions to petitioner's capital. Petitioner is thus not entitled to an interest deduction under section 163(a). Accordingly,

Decision will be entered for the respondent.

---

10 Petitioner relies instead solely on the withdrawn regulations to support its contention that it was adequately capitalized. Although we have chosen not to rely on these regulations in our decision herein (see note 6, supra), we note for the record, that, contrary to petitioner's assertion on brief, petitioner would not have fallen within the safe harbor provided for by respondent under sec. 1.385-6(f)(3) of the withdrawn regulations. Sec. 1.385-6(f)(3) provided for a safe harbor where the corporation's outside ratio was less than or equal to 10:1, and the corporation's inside ratio was less than or equal to 3:1. Since the inside ratio stipulated to by the parties was 3.27:1, petitioner would have fallen outside respondent's safe harbor.

BEST COPY AVAILABLE

COMPLETED
11
Ju 11.7/2:1986-364
nf211

T. C. Memo. 1986-364

ORIGINAL

UNITED STATES TAX COURT

ARNOLD J. KOZIKOWSKI AND SHARON L. KOZIKOWSKI, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7666-83. Filed August 11, 1986.

Arnold J. Kozikowski, pro se.

Oksana O. Xenos, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: Respondent determined a deficiency in petitioners' Federal income tax for 1979 in the amount of $8,441 and an addition to tax under section 6653(a)[1] in the amount of $422. After concessions, the issues are: (1) whether a loss realized by petitioners' wholly owned partnership from the sale

---

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

of commodity futures is ordinary or capital; (2) whether petitioners have satisfied the requirements for a deduction for a charitable contribution; and (3) whether petitioners are liable for the negligence addition under section 6653(a).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners Arnold J. Kozikowski and Sharon L. Kozikowski are husband and wife. At the time the petition was filed, petitioners resided in Fraser, Michigan. Petitioners' 1979 Federal income tax return was timely filed with the Internal Revenue Service Center at Cincinnati, Ohio.

During 1979, Mr. Kozikowski was employed full-time as an automotive designer for the Chrysler Corporation. During 1979, both petitioners were partners in Catalyst's Associated Partnership, and each petitioner held a 50 percent interest in the partnership. Carl Russo, a certified public accountant and a neighbor of the Kozikowskis, prepared the partnership's tax returns. Mr. Russo thought the partnership was originally formed for the purpose of investing in securities and commodity futures and advising people about these activities. While another couple was involved in the partnership in some capacity at an earlier time, in 1979 petitioners owned 100 percent of the partnership. Other than vague suggestions that Mr. Kozikowski may have

BEST COPY AVAILABLE

"counseled" some people with respect to their positions in the securities markets, may have sold a piano, and may have resold some model car kits he purchased at K-Mart, there is no evidence as to the nature of the business of the partnership. There is no evidence that Mr. Kozikowski or the partnership was ever paid for these "counseling" services or ever received any income from sales of any personal property items. The partnership information return (Form 1065) filed by Catalyst's Associated listed its principal business as investments and listed its principal product or service as stocks and bonds. Catalyst's Associated was simply a vehicle for petitioners' personal investments.

During 1979, Catalyst's Associated had gains and losses from silver futures transactions resulting in a net loss of $83,671 as follows:

BEST COPY AVAILABLE

Date Sold[2]	Date Acquired	Gain (Loss)
01-03-79	01-09-79	$ 539.00
01-11-79	01-16-79	2,314.00
10-19-78	01-18-79	(4,067.00)
04-17-78	01-18-79	12,224.00
02-13-79	10-19-78	(5,731.00)
02-13-79	03-22-79	2,270.00
03-08-79	04-18-79	1,345.00
03-30-79	09-06-79	19,375.00
04-03-79	09-06-79	19,350.00
04-16-79	09-06-79	20,175.00
04-19-79	09-06-79	19,428.00
02-27-79	09-06-79	(18,765.00)
03-16-79	09-06-79	(19,265.00)
04-09-79	09-06-79	(18,890.00)
04-26-79	09-06-79	(18,862.00)
10-12-79	05-15-79	(95,111.00)
	Net Loss	($83,671.00)

During 1979, Catalyst's Associated also had gains and losses from the sales of capital stock resulting in a net gain of $8,283 as follows:

Capital Stock	Date Acquired	Date Sold	Gain (Loss)
Northgate Exploration	10-11-77	04-02-79	$1,856.00
Dynalectron	01-10-79	04-06-79	475.00
Harmony Gold Mine	07-07-76	06-07-79	2,393.00
Kinross Mines	07-09-76	06-28-79	3,047.00
Wlkm Gold Mine	04-19-79	07-12-79	835.00
Telex	06-25-79	09-05-79	(225.00)
Chrysler	09-19-79	10-10-79	(98.00)
		Net Gain	$8,283.00

---

2 We have listed this tabulated material exactly as it appears in the parties' stipulation, but it would appear that at the very least the headings have been reversed since in most instances this shows the futures being sold before they have been acquired.

BEST COPY AVAILABLE

Catalyst's Associated traded on the organized commodity and stock exchanges through the brokerage firm of Merrill, Lynch, Pierce, Fenner & Smith. All of the above-listed transactions, both stock and silver futures, were executed by Merrill, Lynch, Pierce, Fenner & Smith.

Mr. Kozikowski was not licensed as a security dealer by the State of Michigan or the Securities and Exchange Commission, nor was he a member of any stock exchange at any time pertinent to this case. Catalyst's Associated bought and sold all of its stocks and silver futures in its own name through the account with Merrill, Lynch, Pierce, Fenner & Smith. Catalyst's Associated did not buy or sell stocks or silver futures for or to any customers; it did not have any customers. Catalyst's Associated did not use silver (the metal) in any manufacturing activity and did not use silver in any business either as a raw material or as an inventory item. While Mr. Kozikowski may have had some silver bars that he held hoping to benefit from price fluctuations, if so, he held the silver as a personal investment and it was not used in any business in which either he or his partnership was engaged.

The record does not establish that Midwest Decoy Association was an organization qualified to receive tax deductible contributions.[3]

---

[3] At the conclusion of the trial the Court held the record open for 60 days to give petitioners an opportunity to furnish documentation to show that (footnote continued)

BEST COPY AVAILABLE

On its 1979 partnership return, Catalyst's Associated treated all the gains and losses from the stock and silver futures transactions as ordinary gains or losses. Catalyst's Associated also deducted $465 as a charitable contribution to the Midwest Decoy Association. The partnership reported a total loss of $75,152 which flowed through to petitioners as the sole partners.

Petitioners' tax returns for the years 1974, 1976, and 1978 had been audited, with no change letters issued for the years 1974 and 1976 and with minor adjustments agreed to for the year 1978. Catalyst's Associated had been in existence since 1976. While the record does not show whether any partnership items were considered or adjusted in these audits, a capital gains issue may have been involved in the audit of the 1978 individual return. Because the partnership return had been prepared by a CPA and because of the prior audits, Mr. Kozikowski believed that respondent had accepted his treatment of both gains and losses from the sale of stock and commodity futures as ordinary income or loss in earlier years. The record does not establish that there had been any prior audit of the partnership returns before the year 1979.

(footnote continued from previous page)
Midwest Decoy Association was a qualified organization. No further documentation or additional stipulation was forthcoming.

BEST COPY AVAILABLE

OPINION

The first issue is the proper classification of the net loss on silver futures as ordinary or capital. This depends on whether the silver futures were "capital assets" within the meaning of section 1221. The term "capital asset" is defined therein as "property held by the taxpayer (whether or not connected with his trade or business)," with certain specific exceptions. Petitioners rely on the exception in section 1221(1) that excludes from the term "capital asset"

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Mr. Kozikowski contends he was a dealer in the trade or business of buying and selling securities. Respondent contends he was a

BEST COPY AVAILABLE

trader or investor who held the silver futures and stock as capital assets.[4] We agree with respondent.

Whether a particular taxpayer is a dealer or a trader is a question of fact. Kemon v. Commissioner, 16 T.C. 1026 (1951). In Kemon, 16 T.C. at 1032-1033, we explained the distinction between a dealer and a trader as follows:

> In determining whether a seller of securities sells to "customers," the merchant analogy has been employed. * * * Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. * * * Such sellers are known as "dealers."
>
> Contrasted to "dealers" are those sellers of securities who perform no such merchandising functions and whose status as to the source of

---

[4] At trial while petitioners' CPA resisted Mr. Kozikowski's efforts to try to get him to say he (Mr. Kozikowski) was a dealer, the CPA seemed to draw a distinction between a trader or investor. The CPA tried to label Mr. Kozikowski as a trader, saying he was in business as an investor, in the business of buying and selling securities as an investment. In different contexts where the tax issue turns on whether the person is engaged in a trade or business, a distinction is sometimes drawn between a trader who is considered to be in a trade or business and an investor who is not. See Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983); Groetzinger v. Commissioner, 82 T.C. 793, 800-801 (1984), affd. 771 F.2d 269 (7th Cir. 1985), cert. granted __ U.S. __ (March 24, 1986); Asch v. Commissioner, T.C. Memo. 1986-238; Zambakian v. Commissioner, T.C. Memo. 1986-219. However, that distinction has no bearing on the determination in the context of the present case of whether stocks, bonds, or other securities are capital assets in the hands of the particular taxpayer, such securities being capital assets in the hands of either a trader or an investor.

As to the gains on the stock sales that petitioners reported as ordinary income, respondent, consistent with his position, determined in the statutory notice that they constitute capital gains.

BEST COPY AVAILABLE

> supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as "traders." [Citations omitted.]

See also Adnee v. Commissioner, 41 T.C. 40 (1963).[5] As the facts of this case clearly demonstrate, Mr. Kozikowski (or his partnership) was a trader, not a dealer. He had no customers who regularly purchased commodity futures or stock in the ordinary course of business. All of the transactions were handled through Merrill, Lynch, Pierce, Fenner & Smith. He was not licensed to sell securities nor was he a member of any stock exchange. See Mirro-Dynamics Corp. v. United States, 374 F.2d 14 (9th Cir. 1967), cert. denied 389 U.S. 896 (1967). Nor was Mr. Kozikowski (or his partnership) engaged in any business which utilized silver. Thus, the silver futures transactions were neither a hedge against raw materials used in a business nor purchases to insure a steady supply of a raw material. Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955); Sicanoff Vegetable Oil Corp. v. Commissioner, 27 T.C. 1056 (1957), revd. on other grounds 251 F.2d 764 (7th Cir. 1958).

---

5 See also Huebschman v. Commissioner, T.C. Memo. 1980-537; Ferguson v. Commissioner, T.C. Memo. 1974-244.

BEST COPY AVAILABLE

Catalyst's Associated deducted $465 under section 170(a) as a charitable contribution to the Midwest Decoy Association. Petitioners have the burden of proving entitlement to the deduction. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Midwest Decoy Association, the recipient of the contribution, is not listed in I.R.S. Publication No. 78[6] and petitioners have failed to establish that it is an organization qualified to receive tax deductible charitable contributions. See n.3, supra.

Respondent also determined that petitioners are liable for the section 6653(a) addition to tax for negligence or intentional disregard of rules and regulations. Petitioners bear the burden of proof on this issue. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972); Rosano v. Commissioner, 46 T.C. 681, 688 (1966). Here petitioners relied on their accountant, who prepared the partnership returns. Because of the accountant's advice and because of the prior audits of their personal returns, petitioners believed that they could report their silver futures losses as ordinary losses. The accountant's advice was erroneous (see n.4, supra), but the Court is satisfied that petitioners

---

6 I.R.S. Publication No. 78 is a cumulative list of all organizations entitled to tax deductible contributions under section 170. It is updated quarterly for additions and monthly in the Internal Revenue Bulletin for deletions.

BEST COPY AVAILABLE

relied upon that advice and acted in good faith. While the issue is close, we cannot conclude that petitioners were negligent or intentionally disregarded rules or regulations.

To reflect the concessions and the above holdings,

Decision will be entered under Rule 155.

BEST COPY AVAILABLE

Ju 11.7/2 :1986-365

COMPLETED
14

AUG 19 1986

MF211

T. C. Memo. 1986-365

ORIGINAL

UNITED STATES TAX COURT

THE MARTIN S. ACKERMAN FOUNDATION, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 10261-83, 8264-84. Filed August 11, 1986.

Martin S. Ackerman and Benjamin Aerenson, for the petitioner.

Lewis R. Mandel, for the respondent.

MEMORANDUM OPINION

TANNENWALD, Judge: Respondent determined the following deficiencies[1] in petitioner's Federal income taxes:

---

1 Pursuant to an order dated April 23, 1985, docket Nos. 10261-83 and 8264-84 were consolidated for trial, briefing, and opinion.

BEST COPY AVAILABLE

Docket No.	Taxable Year Ended	Deficiency
10261-83	November 30, 1979	$2,850
8264-84	November 30, 1980	7,240
	November 30, 1981	7,071

The issue for decision is whether during the years in issue petitioner satisfied the "operational test" of section 1.501(c)(3)-1(c), Income Tax Regs., and therefore qualified as an exempt organization under section 501(c)(3).[2]

These cases were submitted fully stipulated under Rule 122. This reference incorporates herein the stipulation of facts and attached exhibits.

Petitioner is a trust whose legal address was in New York, New York at the time the petitions herein were filed. Petitioner timely filed a return of Private Foundation Exempt from Income Tax (Form 990-PF) for each of its fiscal years ended November 30, 1979, November 30, 1980 and November 30, 1981.

Petitioner is a small, private foundation with non-public sources of support, and was formed under the terms of a trust agreement dated December 18, 1967. During the taxable years at issue, Martin S. Ackerman ("Mr. Ackerman") was a practicing attorney, specializing in art related matters. His address and that of petitioner were the same.

---

2 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

BEST COPY AVAILABLE

The Second paragraph of said agreement described, in pertinent part, that the purposes of the trust:

> are to devote and apply the property of this instrument vested in the [petitioner] and the income to be derived therefrom, exclusively for charitable, religious, scientific, literary or educational purposes, either directly or by contributions to organizations duly authorized to carry on charitable, religious, scientific, literary or educational activities; provided however, that no part of this trust fund shall inure to the benefit of any private shareholder or individual, * * *

Petitioner received a favorable determination letter from respondent, dated February 28, 1968, concluding it was exempt from Federal income tax as an organization described under section 501(c)(3).

During the years in issue, Mr. Ackerman and his wife Diane L. Ackerman (sometimes referred to as "the Ackermans") served without compensation as trustees of petitioner and were also president and controlling stockholder, respectively, of Sovereign American Arts Corp. ("Sovereign"). Sovereign was a private art dealer also organized in 1968.

Prior to its fiscal year ended November 30, 1979, all of petitioner's receipts came in the form of personal contributions from Mr. Ackerman and investment income generated therefrom. During its fiscal year ended November 30, 1979, petitioner received $9,000 in contributions from outside contributors consisting of 90 remittances, each in the amount of $100. During the fiscal years ended November 30, 1980 and November 30, 1981, petitioner received remittances totalling $27,790 and $28,650, respectively, from outside donors. These individual

BEST COPY AVAILABLE

contributions ranged in amounts from $100 to $200. Petitioner's tax returns show total receipts of $11,169 in fiscal 1979, $27,790 in fiscal 1980, and $31,725 in fiscal 1981.

The majority of the remittances received during the 3 fiscal years at issue were made by individuals who had purchased paintings, books and other works of art from Sovereign or Sovereign's wholly owned subsidiaries (hereinafter collectively referred to as "Sovereign"). Mr. Ackerman, in his capacity as a trustee of petitioner, assisted such individuals in making contributions of all or part of this artwork. Such assistance consisted of:

(a) Finding donee organizations to which the artwork could be contributed;

(b) Writing to such donee organizations to see if they would accept such work;

(c) Writing to donors with respect to such assistance and additional communications with the donee organizations;

(d) Providing donors with a statement setting forth the name of the institution, a description of the work donated and the donor's valuation of the work, based on an attached appraisal.

Petitioner also assisted donors and the recipient institutions in arranging for packing and shipping of the works

BEST COPY AVAILABLE

of art donated[3] and in many cases specified the periods during which the works of art were to be on loan to the donee institution prior to the finalization of the gifts. In lieu of his receiving a fee or other compensation for the assistance rendered to the donors, Mr. Ackerman requested that each donor make a contribution to petitioner in recognition of his assistance and in view of the fact that he was the founder of petitioner and one of its trustees. Some donors made such a contribution, others did not.

None of the funds used to assist the donors who made such contributions came from petitioner, but rather from Mr. Ackerman, his wife or Sovereign. Similarly, none of the money so remitted was used in connection with such assistance or in any way related to the charitable contributions of such individuals, and all remittances were used in furtherance of petitioner's activities; except that funds of petitioner were used to pay the salary of Mr. Ackerman's secretary who assisted him in correspondence with the donors and donee organizations.[4]

---

[3] Although this finding is not contained in the stipulation of facts as such, it is clear from the stipulated exhibits that such assistance was provided.

[4] Petitioner had no office of its own but shared the use of a secretary, files and a desk in the office of Mr. Ackerman, for which it is charged a cost. In addition to assisting with the aforementioned correspondence, Mr. Ackerman's secretary also kept the books of account, files and contracts, monitored petitioner's investments and prepared the tax and reporting forms of petitioner. She also assisted petitioner in administering its other programs in support of public charities. See p. 7, infra. Her total cost to petitioner was $100 per week.

BEST COPY AVAILABLE

Petitioner did not publicly advertise the services it offered to individuals wishing to donate works of art to charitable and/or educational institutions during the years in issue. All the donors so assisted by Mr. Ackerman and petitioner learned about petitioner as a result of their social or professional contacts with Mr. Ackerman, or through other individuals with such contacts with Mr. Ackerman. Similarly, petitioner did not publicly advertise the services it offered to donee charitable and/or educational institutions during the years in issue. Petitioner sent letters to various museums, libraries, and other such charitable and/or educational institutions advising them that it was in contact with donors willing to make available books, graphics, sculptures and other works of art as charitable gifts, and inquiring concerning the organization's interest in receiving such gifts. As a result of such letters, petitioner maintained a list of donee organizations to which donations of charitable gifts or works of art could be made.

The individual donors who purchased their artwork from Sovereign or its subsidiaries were advised by either Mr. Ackerman or his wife, prior to their purchases, that petitioner, if they so requested, would be able to assist them in making a donation of the artwork they purchased to a charitable and/or educational institution. Sovereign sold the works of art to the individuals at a profit to itself.

BEST COPY AVAILABLE

Petitioner never assisted individuals in the purchase of works of art. Petitioner, like other foundations, museums and "Friends Organizations" of such museums, did assist individuals who purchased works of art from Sovereign and diverse sources to make donations of such art to museums, art galleries, libraries and universities throughout the United States (these organizations also being tax-exempt under section 501(c)(3), and contributions to these organizations being deductible under section 170).

In addition to the assistance provided to those individuals who desired to contribute works of art to donee institutions, petitioner was also involved in other programs in support of public charities. These programs include direct contributions to, and payments made on behalf of, such charities in order to further their educational, cultural and other tax-exempt purposes. During its fiscal years ended November 30, 1979, November 30, 1980, and November 30, 1981, petitioner made contributions to such charities of $8,970, $7,140, and $22,384, respectively.[5] As of November 30, 1982, petitioner had total assets of $315,656.

---

5 The recipients of these contributions are too numerous to mention, but covered a wide spectrum of institutions, including, but not limited to, art museums, universities, hospitals, a ballet company, public television, libraries, and various humanitarian organizations.

BEST COPY AVAILABLE

The sole issue for decision is whether during the years in issue petitioner satisfied the "operational test" of section 1.501(c)(3)-1(c), Income Tax Regs., and thus qualified for exemption under section 501(c)(3). Section 501(c)(3) requires that an organization must be "operated exclusively for religious, charitable, scientific, * * * literary, or educational purposes," in order to be exempt from taxation under section 501(a). The "operational test," as set forth in respondent's regulations, provides that:

> [a]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. [Section 1.501(c)(3)-(1)(c)(1), Income Tax Regs. Emphasis added.]

The regulations further provide that:

> [a]n organization is not * * * operated exclusively for one or more [exempt purposes] * * * unless it serves a public rather than a private interest. Thus, * * * it is necessary for an organization to establish that it is not * * * operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. [Section 1.501(c)(3)-1(d)(1)(ii), Income Tax Regs. Emphasis added.]

Respondent does not dispute that petitioner satisfies the organizational requirement of section 501(c)(3), and he expressly renounces any claim that section 502, dealing with "feeder" organizations, or section 512, dealing with unrelated business income, is involved herein. See Afro-American Purchasing Center, Inc. v. Commissioner, T.C. Memo. 1978-31.

BEST COPY AVAILABLE

Respondent argues that the services petitioner provided in assisting individuals in making charitable contributions of artwork were in furtherance of a nonexempt purpose, because such services served the private interests of the individual donors and of Mr. Ackerman and his wife. He further asserts that such activity was substantial in nature, thus causing petitioner to run afoul of the requirements of section 1.501(c)(3)-1(c)(1), Income Tax Regs., and to lose its tax-exempt status.[6] Petitioner, on the other hand, contends that the services it provided were in furtherance of its stated charitable purposes, and that any benefits that accrued to either the donors or to Mr. Ackerman and his wife were merely incidental to the public interests served by petitioner's assistance program. For the reasons discussed herein, we agree with respondent.

6

Respondent does not argue that the activities of petitioner violated the requirement of section 501(c)(3) that "no part of the net earnings of [petitioner] inures to the benefit of any private shareholder or individual." See also sec. 1.501(c)(3)-1(c)(2), Income Tax Regs. This requirement and that of sec. 1.501(c)(3)-1(d)(1)(ii), Income Tax Regs., relating to "a public rather than a private interest" are separate requirements (see Canada v. Commissioner, 82 T.C. 973, 981 (1984), and Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202, 215 (1978)), although there are elements common to both (Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337, 345 n. 10 (1980)). In view of respondent's position, we need not directly address the question whether the "inurement" requirement reaches beyond situations where private interests receive benefits from the distribution of funds or the use of art organizations' property. Compare Canada v. Commissioner, supra.

BEST COPY AVAILABLE

The determination as to whether petitioner has satisfied the "operational test" is a question of fact. Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337, 343 (1980). The burden of proof is on petitioner. Rule 142(a); see also Goldsboro Art League, Inc. v. Commissioner, supra at 342. The fact that the case was submitted as fully stipulated does not relieve petitioner of that burden. Cohen v. Commissioner, 20 B.T.A. 647, 648 (1930). For ease of discussion, we will deal first with respondent's claim that the services provided by petitioner served the private interests of the individual donors, and then we will address the issue of the extent, if any, that these services personally benefitted Mr. Ackerman and his wife.

With respect to the donors of the purchased artwork, we agree with petitioner that its activities do not rise to the high level of assistance which caused us to hold for respondent in Christian Stewardship Assistance v. Commissioner, 70 T.C. 1037 (1978). At the same time, we believe that petitioner did more than merely put individuals seeking to donate works of art in touch with donee organizations. The various services are set forth in our findings of fact, see pp. 4-5, supra, and were recognized by the donors through the payment of amounts ranging from $100 to $200. The fact that the donee organizations may have been the principal beneficiaries of petitioner's activities does not negate the flow of benefits to the donors. Christian Stewardship Assistance v. Commissioner, supra at 1042. Similarly, the fact that the expenses of providing such

BEST COPY AVAILABLE

assistance came from the Ackermans or Sovereign rather than petitioner (other than its share of the cost of the secretary, files and a desk, see note 4, supra) all does not conclusively establish that such assistance did not benefit the donors, although it is an element in petitioner's favor in the sense that makes the "commercial hue," see Goldsboro Art League, Inc. v. Commissioner, supra at 342, less apparent. Finally, we note that a measurement of petitioner's role in assisting donors in relation to its overall activities can be found in the fact that the payments from donors constituted $9,000 (more than 80 percent of its total receipts) in fiscal year 1979, $27,790 (100 percent of its total receipts) in fiscal year 1980, and $28,650 (more than 90 percent of its total receipts) in fiscal year 1981.[7] Under the foregoing circumstances, we are unable to conclude that petitioner's activities on behalf of donors of artwork fall within the ambit of cases holding that certain apparently non-exempt activities of an otherwise exempt organization were, relatively speaking, so insubstantial that the organization did not lose its exemption. E.g., Kentucky Bar Foundation v. Commissioner, 78 T.C. 921 (1982); Goldsboro Art League, Inc. v. Commissioner, supra; Industrial Aid for the Blind v.

---

7 Comparable figures for petitioner's contributions are $8,970 for fiscal year 1979, $7,140 for fiscal year 1980, and $22,384 for fiscal year 1981. We note that each of these amounts is less than the amounts of the payments from donors.

BEST COPY AVAILABLE

Commissioner, 73 T.C. 96 (1979).[8] Compare Copyright Clearance Center v. Commissioner, 79 T.C. 793 (1982); Baltimore Health and Welfare Fund v. Commissioner, 69 T.C. 554 (1978).

A similar analysis militates against the conclusion that petitioner's activities were not serving the private interests of Mr. Ackerman and his wife, either via Mr. Ackerman's law practice or via benefits to Sovereign of which they were president and controlling stockholder, respectively. Sovereign was an art dealer. The parties have stipulated that the majority of the donors who made payments to petitioner purchased the works of art, which they contributed to the donee organizations, from Sovereign. The stipulation of facts recites that there were 90 such donors in fiscal year 1979 and respondent has asserted, in his original brief, that there were approximately 200 such donors in each of fiscal years 1980 and 1981. Petitioner did not dispute this assertion in its reply brief, and the stipulated exhibits support the 200 figure. The record, however, is devoid of any evidence as to the total number of purchases of works of art from Sovereign and the volume of Sovereign's annual sales, so that we might determine the ratio of the dollar amounts of sales to donors who utilized the services of petitioner (categorized as to those who paid for such services and those who did not) to Sovereign's total sales. To be sure, the parties have stipulated

---

[8] See also Fraternal Medical Specialist Services, Inc. v. Commissioner, T.C. Memo. 1984-644.

BEST COPY AVAILABLE

that "petitioner did not assist individuals in the purchase of works of art" but they also stipulated that "prior to their purchases" the individuals were advised of the availability of petitioner's services and that Sovereign "sold the works of art to the individuals at a profit to itself."[9] As to the impact of petitioner's activities on Mr. Ackerman's law practice, we observe that the record contains no information of the extent of the professional relationships, in financial terms or otherwise, between Mr. Ackerman and the donors who learned about petitioner as a result of their professional contacts with Mr. Ackerman (see p. 6, supra). Thus the extent of the benefit to Mr. Ackerman in this respect cannot be determined and, as a consequence, we are unable to conclude that the benefits to the Ackermans were so insubstantial as not to jeopardize petitioner's exemption.

The long and the short of the matter is that the fully stipulated record and the inferences which can reasonably be drawn therefrom leave us with too many doubts to enable us to conclude that petitioner has carried its burden of proof that it did not, to a more than insubstantial degree, serve "a private interest." Section 1.501(c)(3)-1(d)(1)(ii), Income Tax Regs.

---

9 Petitioner seeks to buttress its case by arguing that, in many instances, art dealers sit on boards of exempt organizations, and consequently, are in a position to benefit business-wise by helping their customers contribute works of art to the exempt organizations which they serve. Aside from the fact that the record contains no evidence as to this aspect of dealings in the art world generally, we observe that the relationship of such art dealers to the exempt organizations is not likely to have more than an insubstantial impact on the exempt activities of institutions which serve the general public.

BEST COPY AVAILABLE

Responsibility for the circumstances which lead us to our conclusions rests with petitioner. Conservative Gas Co. v. Commissioner, 30 B.T.A. 552, 555 (1934); Cohen v. Commissioner, 20 B.T.A. at 648. Cf. Lane-Wells Co. v. Commissioner, 134 F.2d 977, 979-980 (9th Cir. 1943). See 2 Casey, Federal Tax Practice, sec. 7.38 at p. 239 (1981 rev.).[10]

To reflect the foregoing,

Decisions will be entered for the respondent.

---

10 Petitioner, on brief, discusses the difficulties which small museums encounter in meeting competition for donation of works of art from larger museums. We are not persuaded that such is the case, much less that this situation is so well-known that it can be properly taken into account in the absence of evidence of record. We have similarly disregarded respondent's assertion on brief that the value placed on donated art work by donors was significantly higher than the purchase price paid to Sovereign or its subsidiaries; we have been unable to find any evidence of record to support respondent's assertion and respondent has not indicated where any such evidence exists. Compare Hunter v. Commissioner, T.C. Memo. 1986-308.

BEST COPY AVAILABLE

AUG 19 1986

COMPLETED
9

Ju 11.7/2: 1986-366

CONFIRM

T. C. Memo. 1986-366

ORIGINAL

UNITED STATES TAX COURT

DOUGLAS W. SAMSKI, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 31389-83. Filed August 11, 1986.

Douglas W. Samski, pro se.

William E. Bonano, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: Respondent determined deficiencies and additions to tax due from petitioner for the years 1980 and 1981 as follows:

BEST COPY AVAILABLE

Year	Deficiency	Additions to Tax Sec. 6653(b)[1]	Sec. 6654[2]
1980	$3,850	$1,925	$ 54
1981	4,687	2,344	308

After concessions, the issues for decision are: (1) whether there are deficiencies in petitioner's income tax in the amounts determined by respondent for the years 1980 and 1981; (2) whether petitioner is liable for additions to tax under section 6653(b) for taxable years 1980 and 1981; (3) whether petitioner is liable for an addition to tax under section 6654 for 1981; and (4) whether petitioner is liable for damages under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

When the petition in this case was filed petitioner resided in Modesto, California. Petitioner was a civil engineering technician employed by the City of Modesto during the years here in issue. Petitioner graduated from high school and completed 2 1/2 years of college. He has continued his education by taking

---

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

2 Respondent has conceded that petitioner is not liable for the addition to tax under section 6654 for taxable year 1980.

BEST COPY AVAILABLE

one course per year in night school. Petitioner filed Federal income tax returns reporting various amounts of wage income for the years 1976, 1977, 1978 and 1979.

Petitioner had income from wages for the years 1980 and 1981 in the amounts of $19,941.95 and $22,679.56, respectively. He received Forms W-2 from his employer reflecting those amounts. Petitioner also received interest income in the amount of $96 in 1980 and $58 in 1981. Petitioner is entitled to itemized deductions for the years 1980 and 1981 in the amounts of $3,583 and $3,526, respectively, after allowance for the zero bracket amount.

Petitioner submitted Forms 1040 for the years 1980 and 1981. These forms contained no information from which his taxable income could be determined. The phrases "Object Self-incrimination" or the word "None" appeared opposite each line item, except that the Form 1040 filed by petitioner for 1980 reflected the amount of Federal income tax withheld by his employer. Petitioner was advised by letters dated June 5, 1981, and July 6, 1982, that the Forms 1040 he submitted for 1980 and 1981 were not acceptable as Federal income tax returns. On July 7, 1981, petitioner wrote to the Director of the Internal Revenue Service Center at Fresno, California. In his letter, petitioner stated that the Fifth Amendment of the United States Constitution gave him the right to refuse to provide the information requested on his Federal income tax return.

BEST COPY AVAILABLE

On May 12, 1976, April 10, 1980, and April 28, 1980, petitioner executed and filed with his employer Forms W-4 ("Employees Withholding Allowance Certificate"). On the Form W-4 filed May 12, 1976, petitioner claimed 6 withholding allowances. On the Form W-4 filed April 10, 1980, petitioner claimed 3 withholding allowances. On the Form W-4 filed April 28, 1980, petitioner claimed 4 withholding allowances. Each of these forms reflected the proper number of allowances based on petitioner's marital status and number of dependents at the time the form was filed.

On February 25, 1981, petitioner executed a Form W-4 and filed a Form W-4 with his employer on which he claimed to be exempt from Federal income tax withholding because he did not owe any Federal income tax in 1980 and did not expect to owe any Federal income tax in 1981.

Above the signature line on the Forms W-4 filed by petitioner the following statement appears: "Under the penalties of perjury, I certify that I am entitled to the number of withholding allowances claimed on this certificate, or if claiming exemption from withholding, that I am entitled to claim the exempt status."

In a notice of deficiency dated August 16, 1983, respondent determined deficiencies in petitioner's Federal income tax for 1980 and 1981, and additions to tax thereon under section 6653(b) and section 6654. Mr. Samski filed his petition in this

BEST COPY AVAILABLE

Court on November 7, 1983. In his petition, petitioner stated that the determination of the deficiency and the additions to tax were arbitrarily determined and that this was done solely because petitioner claimed his constitutional rights.

OPINION

The first issue for consideration is whether there is a deficiency in income tax due from petitioner for taxable years 1980 and 1981. The parties have stipulated as to the amount of wage and interest income received by petitioner during those years, and to the amount of excess itemized deductions to which petitioner is entitled. Respondent's determination of the deficiencies is presumptively correct. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). In his Memorandum of Law, petitioner abandons 6 of the 7 arguments he had raised in contesting the deficiencies determined by respondent, including his claims that the notice of deficiency was issued without due process; that under the Fifth Amendment he had a right to object to the questions on the Forms 1040; that the Admiralty-Maritime Court, rather than the Tax Court, has jurisdiction to hear this case; that wages do not constitute taxable income; that the income tax must be apportioned and cannot be applied against petitioner; and that supplying the information required on the Forms 1040 would require petitioner to waive his rights under the Fourth Amendment.

BEST COPY AVAILABLE

Petitioner stipulated that he received wage and interest income for the years in issue, but contends that such income is not taxable. The only argument offered by petitioner in support of his claim that respondent's determinations are incorrect is that the Sixteenth Amendment to the United States Constitution was never ratified by the requisite number of state legislatures. This argument is wholly without merit. United States v. Stahl, 792 F.2d 1438 (9th Cir. 1986); Coleman v. Commissioner, 791 F.2d 68 (7th Cir. 1986).

Petitioner has offered no evidence other than the Sixteenth Amendment argument to overcome the presumption of correctness in the notice of deficiency. Accordingly, we sustain respondent's determination with respect to the deficiencies determined by respondent for taxable years 1980 and 1981.

The second issue for consideration is whether petitioner is liable for additions to tax under section 6654 for taxable year 1981. Section 6654 provides for an addition to tax for underpayments of estimated tax. Respondent has conceded the addition to tax under section 6654 for taxable year 1980. Again, respondent's determination is presumptively correct. Welch v. Helvering, supra; Rule 142(a). Petitioner has offered no evidence on this issue. Therefore, we hold that petitioner is liable for the addition to tax under section 6654 for taxable year 1981.

BEST COPY AVAILABLE

The third issue for consideration is whether petitioner is liable for additions to tax under section 6653(b) for the taxable years at issue herein. Section 6653(b) provides that if any part of an underpayment of tax is due to fraud, there shall be added to that tax an amount equal to 50 percent of the underpayment. Respondent has the burden of proving, by clear and convincing evidence, that there is an underpayment of tax due from petitioner and that some part of the underpayment for each year in issue was due to fraud. Sec. 7454(a); Rule 142(b); Stone v. Commissioner, 56 T.C. 213, 220 (1971). The fraud envisioned by section 6653(b) is actual, intentional wrongdoing, and the intent required is the specific intent to evade a tax believed to be owing. Wilson v. Commissioner, 76 T.C. 623, 634 (1981).

The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978); Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969). Fraud is never presumed, but rather must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Direct proof of the taxpayer's intent is rarely available; therefore, fraud may be proved by circumstantial evidence. Spies v. United States, 317 U.S. 492 (1943); Rowlee v. Commissioner, 80 T.C. 1111, 1123

BEST COPY AVAILABLE

(1983). The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Stone v. Commissioner, supra at 213, 223-224; Otsuki v. Commissioner, supra.

The Forms 1040 filed by petitioner in 1980 and 1981 contained no information from which his income and his tax liability could be determined. Such forms do not constitute income tax returns within the requirements imposed by the Internal Revenue Code. United States v. Porth, 426 F.2d 519 (10th Cir. 1970), cert. denied 400 U.S. 824 (1970); Edwards v. Commissioner, 680 F.2d 1268 (9th Cir. 1982); United States v. Daly, 481 F.2d 28 (8th Cir. 1973), cert. denied 414 U.S. 1064 (1973). Petitioner, therefore, failed to file returns for the years in issue. We have held that for purposes of the fraud addition to tax under section 6653(b), the failure to file a return, standing alone, is not sufficient. Kotmair v. Commissioner, 86 T.C. ___ (June 19, 1986). However, the failure to file a return, together with the submission of false Forms W-4 is sufficient to establish fraud under section 6653(b). Rowlee v. Commissioner, supra; see also Stephenson v. Commissioner, 79 T.C. 995, 1007 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Habersham-Bey v. Commissioner, 78 T.C. 304, 313-314 (1982).

In the instant case, petitioner had filed several proper income tax returns as well as Forms W-4 prior to the taxable years in issue. For taxable year 1980, petitioner failed to file a return. However, he engaged in no other activity which could

BEST COPY AVAILABLE

be considered as evidence of a specific intent to evade a tax believed to be owing. In 1981, however, he filed a false Form W-4 in addition to his failure to file a return. The filing of a false Form W-4, under penalty of perjury, together with the failure to file a return constitutes clear and convincing evidence of fraud under section 6653(b). Therefore, we hold that petitioner is not liable for the addition to tax under section 6653(b) for taxable year 1980, and that petitioner is liable for the addition to tax under section 6653(b) for taxable year 1981.

The final issue for decision is whether petitioner is liable for damages under section 6673.[3] Based on the entire record in this case, we decline to award damages under section 6673.

To reflect concessions of the parties and the foregoing,

Decision will be entered under Rule 155.

---

3 Section 6673 provides:

> Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000.00 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as part of the tax.

BEST COPY AVAILABLE

AUG 19 1986

COMPLETED

4

Ju 11. 7/2: 1986-367

CONTROL

#211

T. C. Memo. 1986-367

ORIGINAL

UNITED STATES TAX COURT

MICHAEL J. CIEKLINSKI, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24626-85. Filed August 11, 1986.

Michael J. Cieklinski, pro se.

Patricia Beary, for the respondent.

MEMORANDUM OPINION

PETERSON, Special Trial Judge: This case was heard pursuant to the provisions of section 7456(d) of the Code[1] and Rule 180.

Respondent determined deficiencies in petitioner's Federal income taxes and additions to tax for the taxable years 1979 and 1980 as follows:

---

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

Year	Deficiency	Additions to Tax Section 6651(a)	Section 6653(a)
1979	$1,319.00	$103.25	$ 65.95
1980	5,137.00	998.25	256.85

The issues for decision are (1) whether petitioner reported his wage income earned during 1979 and 1980; (2) whether petitioner is liable for the addition to tax for delinquency; and (3) whether petitioner is liable for the addition to tax for negligence or intentional disregard of rules and regulations.

During each of the years involved, respondent received Forms W-2 showing that petitioner received $10,677 of income from wages during 1979, and $23,524 of income from wages during 1980. Respondent also determined that petitioner failed to file an income tax return for each of the years at issue. Petitioner does not dispute respondent's determination that he received the wage income, but contends that he filed an income tax return for 1979 and 1980 and reported these amounts as income.

At the trial of this case petitioner had no documentation to support his allegation that he did file the income tax returns in dispute with the Ogden Service Center, Ogden, Utah. To accommodate petitioner the record was left open to allow petitioner time to secure file copies of his returns and any other documentation that would support his claim that the returns were filed. Petitioner failed to submit any evidence that he filed income tax returns for 1979 and 1980.

BEST COPY AVAILABLE

Petitioner bears the burden of proof to show that respondent's determination is in error. Welch v. Helvering, 290 U.S. 111 (1933). Here, petitioner's only evidence that the returns in question were filed is his self-serving statement. Respondent's evidence shows that returns were not filed for 1979 and 1980 with the Ogden Service Center. Petitioner's self-serving statement is clearly insufficient to support his position and to overcome the presumptive correctness of respondent's determination. This is especially true in view of respondent's affirmative proof that income tax returns were not filed. Mears v. Commissioner, T.C. Memo. 1966-173, affd. per curiam 386 F.2d 450 (5th Cir. 1967).

Petitioner also has the burden of proof to show that respondent's determination that he is liable for the additions to tax for delinquency and negligence or intentional disregard of rules and regulations under sections 6651(a) and 6653(a) was in error. Fischer v. Commissioner, 50 T.C. 164, 177 (1968) and Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972).

Under section 6651(a) petitioner must show that his failure to file his income tax returns for 1979 and 1980 was due to reasonable cause. Fischer v. Commissioner, supra. Also, pursuant to section 6653(a), petitioner must show that the underpayment of tax for each of the years 1979 and 1980 was not due to his negligence or intentional disregard of rules and regulations.

BEST COPY AVAILABLE

Petitioner's only evidence with regard to these issues was his testimony that he filed his returns and paid the taxes due thereon. Based on the record in this case we have concluded that petitioner failed to file the returns in dispute. Since petitioner failed to offer any evidence to show that the returns were not filed due to reasonable cause and that he was not negligent with regard to the underpayment of his taxes for each of the years at issue, he has failed to meet his burden of proof. Accordingly, we sustain respondent's determination that petitioner is liable for the additions to tax under sections 6651(a) and 6653(a).

Decision will be entered for the respondent.

BEST COPY AVAILABLE

COMPLETED
12
AUG 19 1986
Jtc 11.7/2:1986-368
mf211

T. C. Memo. 1986-368

ORIGINAL

UNITED STATES TAX COURT

GEORGE E. FEDOR AND HELEN R. FEDOR, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20789-85. Filed August 11, 1986.

The Ohio Department of Liquor Control rejected petitioner-husband's application for renewal of a liquor permit on December 8, 1981. Held: Petitioners' loss was sustained upon rejection of petitioner-husband's application for renewal and not upon expiration of his period for appeal. Therefore, respondent correctly disallowed petitioners' claimed ordinary loss for 1982.

Ronald H. Lasko, for the petitioners.

John H. Gadon, for the respondent.

BEST COPY AVAILABLE

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in petitioners' 1982 Federal income tax of $14,938. After a concession by the parties, the sole issue for decision is whether petitioners are entitled to a section 165[1] ordinary loss deduction in 1982 resulting from the rejection of their application for renewal of a liquor permit in 1981.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners George Fedor and Helen Fedor, husband and wife, resided in Lakewood, Ohio, at the time they filed their petition herein. Helen Fedor is a party only because she filed a joint Federal income tax return with her husband for 1982. Therefore, reference to petitioner shall be deemed to refer to petitioner George Fedor.

Petitioner was a member of the SS. Cyril & Methodius Church of Lakewood, Ohio (Church) at all times relevant herein. On May 21, 1979, petitioner, Reverend Ondreyka, and Peter Shimrak (Shimrak) formed SS. C & M Haven, Inc. (Haven), a nonprofit corporation with its principal office in Lakewood, Ohio. Haven was formed to construct an apartment complex and related facilities specifically designed to meet the physical, social,

---

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

and psychological needs of elderly persons. The planned apartment complex was to be maintained and operated in accordance with a regulatory agreement between Haven and the Department of Housing and Urban Development (HUD). HUD was to insure the mortgages necessary for completion of the project. The Church's parish council agreed to sponsor the construction of the apartment complex on the condition that Haven act as owner and mortgagor. Petitioner served without compensation as president and chairman of the board of trustees of Haven during the period at issue.

The proposed site of the apartment complex consisted of six lots occupied by four buildings and a municipal parking lot. On December 29, 1978, petitioner executed an option agreement with Michael Jarema (Jarema) for the purchase of one of the improved lots. Construction of the apartment complex was contingent upon petitioner acquiring unencumbered title to Jarema's property. Jarema had leased a portion of the property to Flade, Inc. in 1976 for the purpose of operating a tavern business. The lease was for 5 years, and included an option to renew for an additional 3 years with the right of first refusal on any offer to purchase. Flade, Inc. was owned by Charles Flade (Flade) and the tavern business was named Chuck's Place. Flade had obtained a D-5 liquor permit from the Ohio Department of Liquor Control (ODLC)for the operation of Chuck's Place.

BEST COPY AVAILABLE

Jarema was unable to secure a release from the lease held by Flade, Inc. Consequently, petitioner approached Nicholas Hoty (Hoty) about the possibility of acting as petitioner's agent in purchasing the tavern business, liquor permit, and lease. Hoty owned a real estate company that handled commercial property and was familiar with the administrative aspects of owning and transferring liquor permits. Thus, petitioner hoped that Hoty would be able to operate the tavern business, and ultimately resell the liquor permit. Hoty was interested in furthering the apartment complex and agreed to act as petitioner's agent.

On April 12, 1979, Hoty executed an agreement to purchase the tavern business, liquor permit, and lease from Flade, Inc. for $35,000.[2] Pursuant to an agreement between petitioner and Hoty, petitioner was to advance Hoty $28,250 for the purchase and was to sign a note for $5,000 payable to Flade, Inc.[3] The original purchase price was reduced by $1,750 because Hoty waived the sales commission to which he was otherwise entitled. In consideration for agreeing to act as petitioner's agent, Hoty was allowed to operate Chuck's Place for his own account until the tavern business was sold, relocated, or closed. Additionally, Hoty agreed actively to seek a purchaser for the tavern business

---

[2] The tavern business and liquor permit were purchased by Hoty, and thereafter held in Hoty's name, though he was acting as petitioner's agent. Consequently, the Department of Liquor Control communicated directly with Hoty, rather than with petitioner, concerning renewal of the liquor permit.

[3] It is unclear from the record exactly when the sale of Chuck's Place and the transfer of the liquor permit occurred, but the parties have stipulated that $28,250 was paid in 1979 and $5,000 was paid in 1980.

BEST COPY AVAILABLE

and liquor permit on the condition that the tavern business be moved from its present location. Chuck's Place would be allowed to remain at its present location only if the planned apartment complex was canceled.

Hoty attempted to sell the tavern business and liquor permit for approximately 18 months. Hoty found them difficult to sell because Lakewood had very few locations with adequate parking and the owners of rental real estate objected to having taverns operating on their premises. Additionally, Hoty became a born-again Christian in 1980 and lost interest in owning or operating a tavern himself.

On March 31, 1980, Hoty received an offer to purchase the tavern business and liquor permit for $29,000. The offer was contingent upon the purchaser obtaining a lease at the present location for a period of 5 years with an option to renew for an additional 5 years. Petitioner refused the offer because it was necessary to vacate the property for construction of the apartment complex. Hoty received two additional offers for Chuck's Place, but both offers were contingent upon finding a suitable alternative location for the tavern.

On May 1, 1980, Hoty requested the ODLC to place the permit in departmental safekeeping. Hoty's request was granted, and the permit was placed in safekeeping effective May 15, 1980. The permit was due to expire on October 1, 1980, but each permit holder was entitled to renewal of his permit unless rejected for good cause. A permit in safekeeping was not entitled to renewal

BEST COPY AVAILABLE

more than once, however, unless a proposed transfer site was under construction or reconstruction. Hoty renewed the permit in 1980, and attempted to renew it again in 1981.

By letter dated August 28, 1981, the ODLC notified Hoty that he was not entitled to a second renewal in safekeeping in the absence of a proposed transfer site. Additionally, within 15 days subsequent to August 28, 1981, Hoty was required to file an application for transfer of location with the ODLC. The letter concluded that failure to satisfy the transfer requirements by November 1, 1981[4], would result in rejection of the renewal application pursuant to statutory requirements. On December 8, 1981, the ODLC rejected Hoty's application for renewal on the grounds that a permit would not be renewed more than once while in safekeeping. The Department concluded that it was without authority to renew the permit, and that good cause for the rejection of the application had been shown. Pursuant to Ohio law, Hoty had 30 days to appeal the Department's decision to the Liquor Control Commission. Hoty made no such appeal, and the $1,500 renewal fee was refunded to him on February 9, 1982.

On July 10, 1981, petitioner purchased Jarema's property on behalf of Haven for $76,000. The brick house and garage were subsequently razed and the apartment complex was constructed and named Fedor Manor.

---

[4] Pursuant to Ohio Rev. Code Ann. sec. 4303.271(C) (Page 1953), the holder of an expired liquor permit has 30 days from the date of expiration to satisfy the requirements for renewal.

BEST COPY AVAILABLE

In his notice of deficiency dated April 16, 1985, respondent disallowed petitioner's $33,250 ordinary loss, but allowed petitioner a $3,000 capital loss for the expiration of the liquor permit. On May 1, 1986, respondent filed a Motion for Leave to File Amendment to Answer wherein respondent determined that the notice of deficiency incorrectly allowed petitioner a capital loss pursuant to section 165. In his amendment, respondent asserted that the ordinary loss deduction was not allowable because (1) it was not incurred in a trade or business or in a transaction entered into for profit, and (2) it occurred, if at all, in 1981. Respondent's motion to amend his answer was granted subject to an order dated April 28, 1986, granting petitioner's Motion to Shift Burden of Proof to Respondent as to matters raised subsequent to the issuance of the notice of deficiency.

OPINION

The sole issue for decision is whether petitioner is entitled to a section 165 ordinary loss deduction in 1982 resulting from the rejection in 1981 of his application for renewal of the liquor permit. Respondent's contentions that the loss was sustained in 1981 rather than 1982, and that petitioner lacked the requisite profit motive constitute new matters. Therefore, the burden of proof rests with respondent as to these issues. Rule 142(a).

BEST COPY AVAILABLE

Respondent contends that the loss was sustained at the time petitioner's application for renewal was rejected by the ODLC on December 8, 1981. Petitioner maintains that the loss was sustained at the time his period for appeal to the Liquor Control Commission expired on January 7, 1982.

Pursuant to section 165(a), "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Thus, to be deductible under section 165, a loss must be claimed in the taxable year in which it is sustained. This requirement is amplified by the regulations, which provide in pertinent part:

> A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. * * * [Sec. 1.165-1(d)(1), Income Tax Regs.]

See Boehm v. Commissioner, 326 U.S. 287, 292-293 (1945); United States v. White Dental Co., 274 U.S. 398, 403 (1927).

The determination of whether a loss occurred during the taxable year is one of fact. "Such an issue of necessity requires a practical approach, all pertinent facts and circumstances being open to inspection and consideration * * *." Boehm v. Commissioner, supra at 292. The test is flexible and practical rather than legal. Boehm v. Commissioner, supra at 293; Lucas v. American Code Co., 280 U.S. 445, 449 (1930); Ribas v. Commissioner, 54 T.C. 1347 (1970).

BEST COPY AVAILABLE

Based upon the facts before us, we must initially determine when the loss was sustained "as evidenced by closed and completed transactions and as fixed by identifiable events." The safekeeping of liquor permits is controlled by Ohio Rev. Code Ann. section 4303.272 (Page 1982) which provides as follows:

> A permit held in safekeeping shall not be renewed more than once while so held, unless the building from which the permit was taken for safekeeping or the building to which the permit is to be transferred is under construction or reconstruction * * *.

Furthermore, to qualify for a second renewal in safekeeping, the applicant must have on file with the ODLC an application for location transfer. Finally, the applicant must demonstrate that he qualifies for a second renewal no later than 30 days after the expiration date of the liquor permit.

Petitioner requested a second renewal in safekeeping in August 1981. On August 28, 1981, petitioner received a letter from the ODLC advising him that he was not entitled to a second renewal in safekeeping. Petitioner failed to contact the ODLC as required in the letter and did not file an application for location transfer. Additionally, petitioner did not have a proposed site under construction or reconstruction by November 1, 1981; hence, petitioner failed to demonstrate by that date that he qualified for a second renewal. Consequently, on December 8, 1981, the ODLC rejected petitioner's second application for renewal of the liquor permit as required by statute.

BEST COPY AVAILABLE

Petitioner's liquor permit expired on October 1, 1981, but remained in effect until the ODLC acted on his application for renewal. Pursuant to Ohio Rev. Code Ann. section 119.06(c) (Page 1982), the ODLC's order rejecting petitioner's application was not effective prior to 15 days after the notice of rejection was mailed. Thus, petitioner's liquor permit had expired and the rejection order was valid and effective no later than December 24, 1981.

Petitioner maintains, however, that his loss was sustained in 1982 pursuant to section 1.165-1(d)(2)(i), Income Tax Regs., which provides as follows:

> If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. * * *

As discussed above, before a loss may be claimed as a deduction it must be evidenced by a closed and completed transaction. Boehm v. Commissicner, supra at 292-293; United States v. White Dental Co., supra at 403. One of the essential inquiries under the "closed transaction" concept has been whether there exists a substantial possibility that the alleged loss could be recouped. See Boehm v. Commissioner, supra at 294-295; Scofield's Estate v. Commissioner, 266 F.2d 154, 158 (6th Cir. 1959), affg. in part, revg. in part, and remanding in part 25 T.C. 774 (1956); Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 807 (1974), affd. 521 F.2d 786 (4th Cir. 1975). Where a reasonable prospect of

BEST COPY AVAILABLE

recovery has been found to exist, such year was held not to be the proper one in which to claim the loss. Lewellyn v. Electric Reduction Co., 275 U.S. 243, 246-248 (1927); Scofield's Estate v. Commissioner, supra at 159, 163.

Petitioner had 30 days from the date of the rejection order to appeal the ODLC's decision to the Liquor Control Commission. In the event that the Liquor Control Commission sustained the ODLC's order, petitioner had the right to appeal the decision to the Court of Common Pleas. Thus, petitioner had both administrative and judicial rights of appeal. As discussed above, however, Ohio Rev. Code Ann. section 4303.272 explicitly requires that, for a second renewal in safekeeping, the building from which the permit was taken or the building to which the permit is to be transferred be under construction or reconstruction.

On the facts before us, we do not think that petitioner had a "reasonable prospect of recovery" on either his administrative or judicial appeal. Petitioner had no intention of personally operating the tavern business, and neither the original nor an alternative site was under construction or reconstruction. Furthermore, petitioner did not file a location transfer application with the ODLC as required for a second renewal, nor did petitioner present any evidence to the ODLC suggesting that petitioner qualified for a second renewal. Therefore, the ODLC did not have authority to renew the liquor permit and the renewal application was rejected pursuant to statutory requirements. We

BEST COPY AVAILABLE

hold that respondent has met his burden of proof in demonstrating that the loss was sustained upon the ODLC's valid and effective rejection of petitioner's application for renewal in 1981 and not upon expiration of petitioner's right of appeal in 1982.

Having determined that petitioner sustained the loss in 1981, and that petitioner is therefore not entitled to deduct the loss pursuant to section 165(a), we need not reach the issue of whether petitioner purchased the liquor permit with the requisite profit motive.

Decision will be entered for respondent.

BEST COPY AVAILABLE

Jc 11.7/2: 1986-369

T. C. Memo. 1986-369

ORIGINAL

UNITED STATES TAX COURT

NORMAN E. POWELL AND BARBARA POWELL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14749-82. Filed August 11, 1986.

Kenneth Zuckerbrot, Felice F. Mischele, and Robert J. Preminger, for the petitioners.

Michael N. Balsamo and Gregg M. Weiss, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined a deficiency of $78,090.90 in petitioners' 1978 joint Federal income tax. The primary issue for decision is whether petitioners' license activities with respect to "The Ultrasonic Plaque Control

Instrument" were activities not engaged in for profit within the meaning of section 183.[1]

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations of fact and the exhibits attached thereto are incorporated herein by this reference.

Petitioners resided in Plainview, New York when the petition herein was filed. Petitioner[2] is an intelligent individual who has received an extensive academic background as well as practical experience in law and commerce. Petitioner earned an undergraduate degree in accounting, a law degree, and a masters of business administration degree with concentration in finance and taxation. During the year 1978, petitioner was a self-employed attorney. Additionally, during such year, petitioner received wages from World Wide Venture Corporation ("World Wide"), a venture capital subsidiary of a large privately held corporation. Petitioner was a vice-president of World Wide who reviewed potential investments as a real estate and venture capital consultant.

---

1 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

2 Petitioner in the singular form hereinafter refers to petitioner Norman E. Powell.

BEST COPY AVAILABLE

During the year 1978, petitioner anticipated receipt of a substantial and nonrecurring fee with respect to a business transaction commenced during the previous year. Petitioner earned this fee in his capacity as legal and real estate consultant in the acquisition of an office building located in New York City by a European finanical institution. Petitioner received such fee on October 24, 1978. In anticipation of the substantial fee, petitioner sought the investment advice of two business consultants: Peter R. Newman ("Newman"), an attorney and certified public accountant, and Stephen H. Deutsch ("Deutsch"), a certified public accountant. During the year 1978, Newman and Deutsch reviewed the Federal income tax consequences of approximately 50 prospective investments on behalf of petitioner. In October of 1978, Newman and Deutsch recommended that petitioner purchase an exclusive territorial license offered by Ultrasonic Plaque Control Laboratories, Inc. ("UPC") to market and to sell an Ultrasonic Plaque Control Instrument ("the toothbrush"). The toothbrush was developed by Arthur Kuris. The toothbrush is similar to an electric toothbrush in appearance and operation except that the brush head stroke-rapidity of 27,000 oscillations per second purportedly removes plaque, whereas an electric toothbrush performs 40 to 60 oscillations per second.

Petitioner met approximately six times with members of the law firm Schekter, Aber, and Hecht, P.C. ("the Schekter law firm") as such law firm represented UPC. The Schekter law firm

BEST COPY AVAILABLE

furnished petitioner with the offering memorandum relating to the toothbrush license entitled "The Ultrasonic Plaque Control" Technique Information Memorandum Relating to Exclusive License Rights. The offering memorandum states that UPC intends to market the toothbrush through the dentist as opposed to the traditional retail distribution to insure the "appropriate professional image" and the "maximum credibility and serious consumer acceptance." The offering memorandum included a tax opinion written by the Schekter law firm. Petitioner also received with the offering memorandum the following pertinent documents entitled:

I. "Ultrasonic Plaque Control - Average License Financial Illustrations" for years ending December 31, 1978-1986 prepared by the accounting firm of Rose, Feldman, Radner, Parone, and Skehan ("the Feldman financial projection")

II. "Ultrasonic Plaque Control License Evaluation" purportedly prepared by C. Neil Jensen. ("the Jensen report")

III. Effectiveness of an Ultrasonic Toothbrush in a Group of Uninstructed Subjects" written by Dr. Henry M. Goldman and published in the Journal of Periodontology in February, 1974 ("the Goldman article")

Steven Feldman ("Feldman") is a a certified accountant with the accounting firm Rose, Feldman, Radin, Parone & Skehan. Martin Hecht and Leon Schekter of the Schekter law firm engaged Feldman to prepare the Feldman financial projection which attempted to illustrate estimated average license financial operations. The projected figures for sales, cost of goods sold,

BEST COPY AVAILABLE

sales commissions and all other expenses relevant to the projections were provided by the Schekter law firm. Feldman performed no independent auditing or verification procedures regarding any information upon which the projections were based. The Feldman financial projection assumed sales to commence during the year 1981. Feldman prepared a format Form 1040 Schedule C to be used by all licensees but conducted no independent research or analysis as to the substance of the Schekter law firm tax opinion within the offering memorandum. Petitioner's business consultants, Newman and Deutsch did not contact Feldman. Feldman placed three clients in the UPC license arrangement and received compensation from UPC.

Petitioner elected the accrual method of accounting concerning his UPC license activity. On his 1978 Form 1040 Schedule C petitioner deducted the following amounts:

Advertising	$74,800.00
Legal and Professional Services	40,000.00
Amortization	22,222.00
Interest on Business Indebtedness	480.00
Selling Expenses	100.00
Office Expenses	15.00
	$137,617.00

Respondent disallowed the entire amount within the statutory notice of deficiency.

Neil Jensen ("Jensen") was associated with Lactona Corporation, the dental division of Warner Lambert Corporation. Jensen became aware of UPC during the year 1978. John Woodcock ("Woodcock") telephoned Jensen on behalf of UPC. Prior to 1978, Jensen had met Woodcock at various dental conventions. Jensen

BEST COPY AVAILABLE

met twice with Woodcock on December 8 and 9, 1978 to discuss the potential market for a plaque removal device. Jensen performed a limited analysis and located several dental articles in preparation for the meetings with Woodcock. Each meeting lasted about four hours and Jensen billed Woodcock for eight hours of services in the amount of $200.00. Jensen was not aware that UPC intended to license the toothbrush by territory. Jensen was not provided the Feldman financial projection, sales data, offering memorandum, or license agreement. Jensen was not contacted by petitioner or any of petitioner's consultants until March of 1984. The Jensen report dated November 17, 1978 and furnished to petitioner by UPC as a promotional item was not written or signed by Jensen.

Dr. Henry M. Goldman ("Dr. Goldman") is a periodontist and professor at the Henry M. Goldman School of Graduate Dentistry at Boston University. Dr. Goldman is a noted periodontist who enjoys a reputation of high standing within the dental community. Dr. Goldman tested an ultrasonic toothbrush during the year 1972. The Boston University Graduate School of Dentistry was not involved in this research. Dr. Goldman's experimentation with an ultrasonic toothbrush was not extensive and was intended to encourage research by other periodontists. In this regard Dr. Goldman published his research in the Journal of Periodontology in February of 1974. Dr. Goldman was unaware that UPC distributed the Goldman article to promote the sale of UPC licenses. In September of 1979, Dr. Goldman was informed by the

BEST COPY AVAILABLE

Securities and Exchange Commission that UPC used the Goldman article and referred to his research within the UPC promotional material. An attorney hired by Dr. Goldman informed the Schekter law firm and UPC by letter dated October 24, 1979 to refrain from further reference or use of Dr. Goldman's name or research. The statements attributed to Dr. Goldman by UPC were exaggerated and generally untrue as well as unauthorized.

Petitioner signed a license agreement dated December 21, 1978 with UPC. Petitioner, as licensee, agreed to pay UPC, as licensor, a license fee in total sum of $200,000 payable as follows:

> (a) The sum of $13,000 in cash or certified check
> (b) The sum of $12,000 by negotiable promissory note executed and delivered to licensor on or before February 1, 1979 with interest at the rate of seven percent per annum accompanied by an irrevocable letter of credit ("the license fee recourse note")
> (c) The sum of $175,000 by non-recourse promissory note due January 1, 1986 ("the license fee nonrecourse note")

The license fee nonrecourse note dated December 21, 1978 required quarterly payments of principal and interest determined by multiplying the number of toothbrushes sold and paid for during the prior calendar quarter by $5.00. As security for the license fee nonrecourse note, petitioner granted a security interest to UPC in the license, any inventory, and any amounts receivable. The license commenced on December 21, 1978 and will terminate on December 31, 1986. The license agreement included a renewal

BEST COPY AVAILABLE

option of five years provided that petitioner exercised such option on or before December 21, 1983, tendered $12,500 cash payment and $37,500 nonrecourse promissory note.

The UPC license agreement also provided that each licensee contribute the amount of $74,800 to the Advertising and Promotional Fund administered by Hanson, Fassler & Associates, Inc. ("Hanson Fassler"), an advertising concern, payable in the amount of $10,800 cash and $64,000 nonrecourse note ("the advertising nonrecourse note"). The advertising nonrecourse note required quarterly payments of principal and interest determined by multiplying the number of toothbrushes sold and paid for by the sum of $2.00. The advertising nonrecourse note was secured by the same collateral that secured the license fee nonrecourse note. Herbert Fassler ("Fassler") of Hanson Fassler first learned in April of 1984 that under the UPC license agreement petitioner executed the advertising nonrecourse promissory note payable to the order of Hanson Fassler. Hanson Fassler billed UPC for actual work performed and costs incurred and payment was not dependent upon sales. Hanson Fassler terminated the relationship with UPC in 1982 but continued to market an ultrasonic dental device.

On December 21, 1978, petitioner executed an optional sales agency agreement for a term of one year with Dental Sales Consultants ("DSC") as "exclusive sales agent" for the toothbrush within petitioner's license territories. Woodcock signed the sales agency agreement on behalf of DSC. The sales agency

BEST COPY AVAILABLE

agreement required payment in the amount of $1,200 cash upon the execution of the agreement and $1.00 for each toothbrush sold by the agent for which payment was received.

Petitioner on December 29, 1978 executed a nonrecourse note in the amount of $40,000 due on January 1, 1986 payable to Newman and Deutsch ("the tax advice nonrecourse note") in consideration of their review of the Federal income tax consequences of approximately 50 investments. The tax advice non-recourse note required quarterly payments of principal and interest in an amount determined by multiplying the number of toothbrushes sold and paid for by the sum of $5.00. The tax advice nonrecourse note was subordinate to the license fee nonrecourse note and the advertising nonrecourse note and no payment of principal or interest was due until such notes were paid in full. Petitioner did not sign the tax advice nonrecourse note.

Dr. Herbert I. Oshrain ("Dr. Oshrain") has been a practicing periodontist since 1958 and was a professor at Columbia University Dental School. Dr. Oshrain conducted a clinical test on an ultrasonic toothbrush in 1973 under the auspices of Columbia University. The conclusion of Dr. Oshrain was that the ultrasonic toothbrush was no more effective that a manual toothbrush in the removal of plaque.

Dr. Burton Wasserman ("Dr. Wasserman"), the Director of Dentistry at Booth Memorial Hospital, conducted tests on the toothbrush but has not attained conclusive results. Dr. Wasserman and Fassler became acquainted during the year 1981.

BEST COPY AVAILABLE

Dr. Wasserman conducted two series of tests during the years 1981 and 1983 regarding the toothbrush. In December of 1983, Fassler arranged to exhibit the toothbrush at the Greater New York Dental Show ("the dental exhibition") under the auspices of Booth Memorial Hospital for which Fassler developed a promotional pamphlet for distribution. Fassler arranged for petitioner to attend the dental exhibition as a guest. UPC did not furnish any funds regarding the dental exhibition as the relationship between Hanson Fassler and UPC was terminated during 1982 because UPC lacked sufficient funds to continue the marketing efforts of Hanson Fassler. Even though the relationship between Hanson Fassler and UPC terminated in 1982, Hanson Fassler continued to develop a marketing strategy for the toothbrush. Fassler indicated that the dental device displayed at the dental exhibition may not be the toothbrush subject to petitioner's UPC license and that an ownership dispute between Arthur Kuris, the inventor of the toothbrush, and UPC existed in that regard.

At the time petitioner invested in his license territories, petitioner was advised that the toothbrush required further market research to determine an appropriate pricing structure and clinical testing for Food and Drug Administration ("FDA") approval. Petitioner was advised that the toothbrush could not be distributed for sale until 18 to 24 months from December of 1978. Petitioner applied for the necessary state documents such as a certificate to do business in Nassau County as the Normal E.

BEST COPY AVAILABLE

Powell Hygiene Products Company and a sales tax license. Petitioner never maintained a separate bank account or separate books and records concerning his UPC license activities.

During the years 1979 through 1982, petitioner corresponded with Joshua H. Weisberger, President of UPC and president of M.E.J. Management Corporation, an entity engaged by UPC to manage dental license operations in January of 1980. Petitioner initiated or received five items of such correspondence with Joshua H. Weisberger during 1979, two items during 1980, and one item during 1982. Petitioner maintained contemporaneous albeit cyptic, barely intelligible notes of his license activities which regarding the efforts of Fassler and Joshua H. Weisberger regarding the marketing, manufacturing, and FDA problems of the toothbrush.

OPINION

The primary issue for decision is whether petitioners are entitled to deduct expenses attendant to the UPC territorial license activities. Respondent's disallowance of such expenses is premised upon the determination within the statutory notice of deficiency that petitioners' UPC license activities were not engaged in for profit within the meaning of section 183. In the alternative, respondent asserts that the nonrecourse notes executed by petitioner with regard to the UPC license were not bona fide indebtedness for tax purposes. Based upon our determinations herein, we need not address respondent's remaining alternative arguments. Respondent also determined within the

BEST COPY AVAILABLE

statutory notice of deficiency that petitioners received $328.00 of unreported interest income. Respondent's determination is presumptively correct. Petitioners failed to satisfy the burden of proof as to such interest income. Rule 142(a).

Section 183 is an allowance provision, rather than a disallowance provision, which may operate to permit certain deductions for activities not motivated by profit. Brannen v. Commissioner, 78 T.C. 471, 500 (1982), affd. 722 F.2d 695 (11th Cir. 1984); Engdahl v. Commissioner, 72 T.C. 659, 666 (1979). Section 183(a) provides in the case of an activity engaged in by an individual or electing small business corporation, that if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed except as provided within section 183(b). An "activity not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraphs (1) or (2) of section 212." If such activity is not engaged in for profit, section 183(b) separates the claimed deductions into two categories. Section 183(b)(1) allows deductions which are not dependent upon a profit motive. Section 183(b)(2) allows the balance of such deductions which would otherwise be permitted only if such activity was engaged in for profit limited to the extent that gross income derived from the activity exceeds the deductions allowed under section 183(b)(1).

BEST COPY AVAILABLE

Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In order to constitute the carrying on of a trade or business under section 162, an activity must be entered into, in good faith, with the dominant objective of realizing a profit therefrom. Dreicer v. Commissioner, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. cir. 1983); Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; See also Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984), affg. 78 T.C. 471 (1982); Hager v. Commissioner, 76 T.C. 759 (1981), and cases cited therein. "Profit," in this context, means economic profit, independent of tax savings. Surloff v. Commissioner, 81 T.C. 210 (1983).

The issue of whether a taxpayer engages in an activity with the requisite intention of making a profit is one of fact to be resolved on the basis of all the surrounding facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; Engdahl v. Commissioner, 72 T.C. 659 (1979); Allen v. Commissioner, 72 T.C. 28 (1979). In determining whether an activity is engaged in for profit, the following factors are to be considered: (1) The expertise of the taxpayer in carrying on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other

BEST COPY AVAILABLE

similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Sec. 1.183-2(b), Income Tax Regs.; Boyer v. Commissioner, 69 T.C. 521 (1977); Benz v. Commissioner, 63 T.C. 375 (1974). It is not intended, however, that only the aforesaid factors be taken into account in making the determination. Sec. 1.183-2(b), Income Tax Regs. No single factor is determinative and the issue is to be resolved by examining all the circumstances. Fuchs v. Commissioner, 83 T.C. 79,98 (1984); Dean v. Commissioner, 83 T.C. 56, 74 (1984); Flowers v. Commissioner, 80 T.C. 914, 931 (1983); Dunn v. Commissioner, 70 T.C. 715, 720 (1978), affd. 615 F.2d 578 (2d Cir. 1980). In our determination, we ascribe greater weight to objective factors than to mere statements of intent. Fuchs v. Commissioner, supra; Siegel v. Commissioner, 78 T.C. 659, 699 (1982); Engdahl v. Commissioner, supra.

Respondent's determinations are presumptively correct. Welch v. Helvering, 290 U.S. 111 (1933). Petitioner bears the burden of proof. Rule 142(a).

Based upon our review of the entire record, we determine that petitioner's UPC license activities were not engaged in with a profit objective. The mere execution of the necessary paperwork to acquire a territorial license does not constitute a trade or business. Herrick v. Commissioner, 85 T.C. 237 (1985);

BEST COPY AVAILABLE

Compare Waddell v. Commissioner, 86 T.C. 848 (1986). We are convinced that petitioner executed the required paperwork to engage in the UPC license activity primarily, if not exclusively, to obtain the tax advantages stated within the offering memorandum. Petitioner earned a law degree and masters of business administration degree with concentration in finance and taxation. We found petitioner to be an intelligent and sophisticated individual. During the year in issue, petitioner was a self employed attorney. Additionally, during such year, petitioner was an employee and Vice-President of World Wide, a venture capital concern. Petitioner served World Wide as a real estate and venture capital consultant. However, petitioner was not a credible witness and we find inconsistencies concerning his testimony. We note that petitioner testified at trial that he had not renewed the UPC license since it had not expired. The UPC license agreement is unambiguous that the renewal option was available provided petitioner served UPC "written notice of his intention to extend and renew this agreement no later than the fifth (5th) anniversary of the commencement date."[3] Accordingly, the renewal option lapsed on December 21, 1983 as petitioner did not comply with the written notice requirement. Petitioner's inconsistency is unexplained. Petitioner also engaged DSC as exclusive sales agent for a term of one year commencing December

---

3 The renewal provision stated that the license may be renewed for the fee of $100,000.00 payable by $12,500 cash and $37,500 by nonrecourse promissory note. The principle amount of cash and nonrecourse note is only $50,000.00.

BEST COPY AVAILABLE

21, 1978. Petitioner knew that no sales could occur for 18 to 24 months from the inception of his participation. Furthermore, the need for a sales agent is inconsistent with petitioner's testimony that he desired to involve himself personally with the marketing efforts of the toothbrush. Petitioner testified that he bargained for the two specific territories because of the presence of major department stores in shopping malls within such territories. Such testimony is inconsistent with the stated intention of UPC to market the toothbrush through the dentist as opposed to traditional retail distribution. Lastly, petitioner stated that since the year 1983 he had decided "to take the bull by the horns and contact potential manufacturers." The UPC license agreement is unambiguous that petitioner acquire all toothbrush units from UPC. Licensee manufacturing is not contemplated by the license agreement. Petitioner's testimony is fundamentally flawed and inconsistent with basic aspects of the agreement and we find his stated intention as to manufacturing the toothbrush himself to be illustrative of "bull" of another sort.

We have examined petitioner's level of expertise and the expertise of those individuals whom petitioner contacted regarding the toothbrush. Section 1.183-2(b)(2), Income Tax Regs. We do not think, and petitioners do not assert, that petitioner's educational background and professional investment savvy directly translated into expertise regarding ultrasonic dental devices. In the evaluation of the UPC license

BEST COPY AVAILABLE

opportunity, petitioner relied solely upon his business advisors Newman, an attorney and certified public accountant, and Deutsch, a certified public accountant. The inquiry of Newman and Deutsch was limited to an analysis of the tax opinion within the offering memorandum and an inquiry regarding the reputation of the Schekter law firm. Prior to his involvement, petitioner met with members of the Schekter law firm, however, it is clear from the record that the Schekter law firm was involved with the promotion of the UPC license activity and that petitioner met with the Schekter law firm solely to receive and execute UPC paperwork.

We find particularly fatal to petitioner's profit objective assertions that petitioner and his advisors failed to investigate the representations within the promotional material. During the year in issue, Dr. Goldman was unaware that UPC distributed his research to promote the sale of UPC licenses for an ultrasonic dental device. In September of 1979, the Securities and Exchange Commissioner informed Dr. Goldman that UPC distributed his research to promote UPC licenses. The promotional materials made unauthorized and inaccurate references to Dr. Goldman, the Goldman article, and the Boston University Graduate School of Dentistry. Petitioner and his advisors were aware that the toothbrush employed new technology not yet perfected for consumer use. We find it incredulous that petitioner and his advisors failed to contact Dr. Goldman during the year in issue regarding the clinical aspects of the toothbrush so as to verify the representations within the offering memorandum. Dr. Goldman

BEST COPY AVAILABLE

testified at trial that the UPC representations were "ridiculous statements that bothered the heck out of me." Such minimal investigation would have ascertained that serious clinical considerations existed concerning the toothbrush and that the credibility of the UPC promotion was in serious doubt due to the unauthorized reference to Dr. Goldman, the Goldman article and the Boston University Graduate School of Dentistry.

The Jensen report dated November 17, 1978 and furnished to petitioner by UPC as a promotional item was not written or signed by Jensen. Jensen met with Woodcock in December of 1978. The Jensen report purported to evaluate the UPC license from a marketing perspective with specific reference to the Feldman projection. Jensen testified that he was unaware that UPC intended to franchise territorial licenses and that he did not review the Feldman financial projection. Petitioner and his business advisors did not contact Jensen during the year in issue. Minimal investigation would have ascertained that the Jensen report was totally unauthorized and fabricated.

Petitioner and his advisors did not investigate the UPC license opportunity beyond the purview of the purported tax consequences. Starkly evident from the record is the inescapable conclusion that a cursory investigation would have uncovered the spurious representations made by UPC within the promotional materials. Petitioner's sole motivation was to minimize the tax consequences of the substantial and nonrecurring fee received during the year in issue. Failure to undertake fundamental and

BEST COPY AVAILABLE

elementary inquiries and to obtain expert advice in a transaction of this nature and magnitude is not consistent with ordinary business practice. Herrick v. Commissioner, supra at 256. The grave misrepresentations of UPC within the promotional materials heightened by the ease with which a prudent, yet unsophisticated, investor would have exposed the deception belie a determination that petitioner engaged in the UPC license activity for profit.

The record indicates a history of substantial deductions attributable to petitioner's 1978 year end UPC investment.[4] No sales were consummated as of the date of trial. Herrick v. Commissioner, supra at 258; sec. 1.183-2(b)(8), Income Tax Regs. We are convinced that petitioner entered the UPC license arrangement solely to offset the tax consequence of the substantial and nonrecurring fee which he had earned in his capacity as a legal and real estate consultant. We are further convinced that the tax advice nonrecourse note in the amount of $40,000 which petitioner accrued and deducted in total as legal and professional services on his 1978 Form 1040 Schedule C relating to the toothbrush activity was executed with the primary intent of tax avoidance to further offset the tax consequences of the substantial and nonrecurring fee.

---

[4] Petitioner claimed a loss in the amount of $37,380.00 regarding his UPC license activities on his joint 1979 Federal income tax return.

BEST COPY AVAILABLE

We determine that petitioner is not entitled to business deductions under section 162 due to the absence of profit objective. Section 1253(d) governs the treatment of payments made by a transferee of a franchise.[5] If the payments are "contingent on the productivity, use, or disposition of the franchise," section 1253(d)(1) provides that such payments are deductible within the meaning of section 162. If the payments made by a transferee are not contingent, section 1253(d)(2) governs the tax treatment. Section 1253(d)(2) provides the period over which a transferee may deduct fixed payments depending on whether the license obligation is paid off with a single payment, approximately equal payments, or by any other arrangement for payment. This Court recently held that section 1253(d)(2) embodies a trade or business requirement despite the absence of a specific reference thereto. Herrick v. Commissioner, supra at 266. The use of notes or other valuable property can constitute payment under section 1253(d)(2) provided that the note or property "paid" is not demonstrated to be illusory or without value. Jackson v. Commissioner, 86 T.C. 492, 521 (1986). Petitioner is not entitled to amortize the UPC

---

5 The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specific area. Sec. 1253(b)(1).

BEST COPY AVAILABLE

license acquisition fee under section 1253(d)(2) as petitioner did not engage in the UPC license activity within the meaning of section 162.

Section 183(b)(1) allows deductions otherwise allowable without regard to whether or not an activity is engaged in for profit. Section 163 provides that a deduction shall be allowed for all interest paid or accrued within the taxable year of indebtedness. Section 212(3) provides the allowance of ordinary and necessary expenses paid or incurred in connection with the determination, collection, or refund of any tax. We determine that petitioner failed to establish an entitlement to deduct expenses under any provision without regard to whether the UPC license activity was engaged in for profit.

Petitioner executed three nonrecourse promissory notes and an interest bearing recourse promissory note regarding the toothbrush activity. Each nonrecourse promissory note required quarterly payments of principal and interest determined by multiplying the number of toothbrush units sold and for which payment was collected.[6] On his Form 1040 Schedule C regarding his UPC license activity, petitioner claimed a deduction in the amount of $480.00 as interest on business indebtedness,

---

6

Nonrecourse Notes	Principal Amount	Per Unit Payment
The license fee nonrecourse note	$175,000	$5.00
The advertising nonrecourse note	64,000	2.00
The tax advice nonrecourse note	40,000	5.00

BEST COPY AVAILABLE

presumably on the $12,000.00 license fee recourse note bearing seven percent interest due February 1, 1979. Petitioner accrued a deduction in the amount of $40,000 for the full amount of the tax advice nonrecourse note executed to Newman and Deutsch. As of the trial date, no sales were generated as no toothbrushes were manufactured. The record is devoid of any evidence to establish that the license fee recourse note was in fact executed as the only reference to such note is within the license agreement. Consequently, petitioner has failed to satisfy the burden of proof necessary to establish an entitlement to an interest deduction relative to the license fee recourse note. Furthermore, because we have determined that the accrual based toothbrush activity was an activity not engaged in for profit as defined within section 183, petitioner must establish a cash basis entitlement to the otherwise available interest deduction. Petitioner failed to satisfy the burden of proof that such note was in fact executed and delivered or that interest was paid. We also determine that each nonrecourse promissory note was not bona fide indebtedness for tax purposes. Consequently, petitioner is not entitled to deduct any amount pursuant to section 163, and petitioner's assertion that the tax advice nonrecourse promissory note is deductible pursuant to section 212(3) is without merit.

It is well settled that in order for a liability to be accruable, it must be binding and enforceable; must not be contingent on a future event; the liability must be certain; and

BEST COPY AVAILABLE

there must be a reasonable belief on the part of the debtor that the liability will be paid. Herrick v. Commissioner, supra at 260; Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), affd. 601 F.2d 734 (5th Cir. 1979); United Control Corp. v. Commissioner, 38 T.C. 957 (1962). We are satisfied that the nonrecourse notes herein do not satisfy the aforesaid requirements and are not properly accruable. Herrick v. Commissioner, supra at 260. Furthermore, quarterly payment of principal and interest was to be determined solely based upon the number of units sold for which payment was collected. In the instant case, the toothbrush was a highly speculative product not manufactured and not available for distribution at the time the notes were executed. We determine that the non-recourse notes were contingent and that payment was remote. Estate of Baron v. Commissioner, 83 T.C. 542 (1984); Saviano v. Commissioner, 80 T.C. 955 (1983) affd. 765 F.2d 643 (7th Cir. 1985). Compare Jackson v. Commissioner, 86 T.C. 492 (1986). The tax advice nonrecourse note was a totally illusory and transparent attempt to generate an exaggerated loss in the investment year. The tax advice nonrecourse note was not signed by petitioner and petitioner failed to establish whether such note was in fact executed and delivered to Newman and Deutsch. Consequently, the tax advice nonrecourse note was not genuine indebtedness and no amount is deductible under section 212(3) irrespective of the method of accounting employed by petitioner.

BEST COPY AVAILABLE

Petitioner asserts, by reference within the petition, the trial memorandum, and reply brief, an entitlement to elect the income averaging provisions of sections 1301 to 1305 inclusive. The record does not include any relevant information, concerning the "base period" taxable years. Sec. 1302(c)(2). The income averaging election may be effectuated for the first time before the Court. Hosking v. Commissioner, 62 T.C. 635 (1974). The only issue in Hosking was the timeliness of the election made at trial, and all facts as to the correct amount of taxable income for each base period taxable year were within the record.[7] In Cloes v. Commissioner, 79 T.C. 933 (1982), we determined that the income averaging provisions constitute new issues which may not be raised in a Rule 155 proceeding. We stated in Cloes that the income averaging provisions place each base period year before the Court and that respondent may contest any and all items of income and deduction for the base period years. Cloes, 79 T.C. supra at 937. Petitioner has not satisfied the burden of proof necessary to establish an entitlement to the income averaging provisions as petitioner presented no evidence concerning the base period years.

Decision will be entered for the respondent.

---

7 Pereira v. Commissioner, T. C. Memo. 1976-66, n. 2.

BEST COPY AVAILABLE

COMPLETED
7
AUG 19 1986

Ju 11.7/2:1986-370

mf211

CENTRAL

T. C. Memo. 1986-370

ORIGINAL

UNITED STATES TAX COURT

LEATRICE GERMAN, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7077-84. Filed August 11, 1986.

Petitioner, a guidance counselor, participated in a fashion study course that involved traveling to Israel, Egypt and Spain. Petitioner claimed a deduction for the expenses she incurred from participating in the course, which respondent disallowed. Held, petitioner is not entitled to a deduction for these expenses because she failed to establish that such expenses were incurred to maintain or improve her skills as a guidance counselor.

Carl Noah German, for the petitioner.

Maureen C. Kopko and H. Karl Zeswitz, for the respondent.

BEST COPY AVAILABLE

MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, Chief Judge: By notice of deficiency dated December 20, 1983, respondent determined a deficiency in petitioner's Federal income tax for the taxable year ended December 31, 1980 in the amount of $910.44. After concessions, the sole issue before us is whether petitioner is entitled to deduct certain expenditures as educational expenses under section 162(a).[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner, Leatrice German, resided in Wynnewood, Pennsylvania when the petition was filed in this case. Petitioner timely filed her Federal income tax return for the taxable year 1980 with the Internal Revenue Service Center in Philadelphia, Pennsylvania.

During 1980, petitioner was employed as a guidance counselor by the Philadelphia School District. As a counselor, petitioner's job responsibilities included providing counseling and guidance services for students with respect to personal, social, educational and career development matters.

---

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

While on summer break from her employment, petitioner participated in a 3-week fashion study course that involved traveling to Israel, Egypt and Spain. Petitioner did not receive any credit for her participation in this course, which was offered by Temple University. In deciding whether to take this course, petitioner did not examine any syllabus, itinerary or curriculum that described the course. Petitioner also did not keep a diary or journal of her activities while in Israel, Egypt and Spain.

Petitioner's employer did not require her to take this course, and she was not reimbursed for her expenses. On her Federal income tax return filed for the taxable year 1980, petitioner deducted $1,502 for expenses incurred in taking this fashion study course. In his notice of deficiency, respondent disallowed this claimed deduction. Respondent's disallowance was based on his determination that the expenses were not incurred to maintain or improve skills required in her employment but rather were incurred for personal reasons.

OPINION

We must determine whether the expenses petitioner incurred from her participation in the fashion study course are deductible under section 162(a).

Section 162(a) allows a taxpayer a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 262

BEST COPY AVAILABLE

expressly disallows a deduction for "personal, living, or family expenses," and section 1.262-1(b)(9), Income Tax Regs., provides that "Expenditures made by a taxpayer in obtaining an education or in furthering his education are not deductible unless they qualify under section 162 and §1.162-5 * * *." Section 1.162-5, Income Tax Regs., sets forth objective criteria for distinguishing between those expenses which are business expenses and those which are personal expenditures. This regulation, with certain exceptions not relevant here,[2] provides that educational expenses are deductible as ordinary and necessary business expenses if the education (1) maintains or improves skills required by the individual in his employment or other trade or business, or (2) meets the express requirements of the individual's employer. Sec. 1.162-5(a), Income Tax Regs.[3]

---

[2] Such exceptions are for expenditures for education required for an individual to meet the minimum educational requirements of his employment or other trade or business or education which qualifies the individual for a new trade or business. Sec. 1.162-5(b)(2) and (3), Income Tax Regs. Respondent does not argue that petitioner's expenses come within such exceptions.

[3] See also sec. 1.162-5(d), Income Tax Regs., which provides, in part, as follows:

> (d) Travel as a form of education.
> * * * [E]xpenditures for travel * * * as a form of education are deductible only to the extent such expenditures are attributable to a period of travel that is directly related to the duties of the individual in his employment or other trade or business. For this purpose, a period of travel shall be considered directly related to the duties of an individual in his employment or other trade or business only if the major portion of the activities during such period is of a nature which directly maintains or improves skills required by

(footnote continued)

BEST COPY AVAILABLE

Whether education maintains or improves skills required by the taxpayer's employment is a question of fact. Baker v. Commissioner, 51 T.C. 243, 247 (1968). The burden of proof is on the taxpayer. Welch v. Helvering, 290 U.S. 111 (1933); Boser v. Commissioner, 77 T.C. 1124, 1131 (1981); Rule 142(a). In order to meet such burden, petitioner must demonstrate that there was a direct and proximate relationship with respect to the fashion study course and the skills required in her employment as a guidance counselor. Kornhauser v. United States, 276 U.S. 145, 153 (1928); Takahashi v. Commissioner, 87 T.C. ___ (July 21, 1986); Boser v. Commissioner, supra at 1131.

The record clearly shows that the travel undertaken pursuant to the course offered by Temple University was not required by her employer. Therefore, in order for these expenses to be deductible, petitioner must establish that the expenditures were made for education which maintained or improved the skills required in her employment as a guidance counselor. This petitioner has failed to do.

There is nothing in the record that shows that petitioner's skills as a guidance counselor were maintained or improved by virtue of her travel pursuant to the fashion study course. The fact that petitioner signed up for the course without first examining a syllabus, itinerary or curriculum that described the

---

(footnote continued from previous page)
the individual in such employment or other trade or business. * * *

BEST COPY AVAILABLE

course suggests to us that her travels were undertaken for personal, not business, purposes. Had petitioner truly intended to obtain information or experiences useful in her job, she would have done some advance investigation and planning to assure that her participation in the fashion study course would maintain or improve her skills as a guidance counselor.

Petitioner testified that her skills as a guidance counselor were enhanced by traveling to Israel, Egypt and Spain because she was in a better position to present a picture of the outside world. She introduced no evidence, however, to demonstrate that she used any materials obtained or knowledge gained from such travel in counseling the students. Petitioner also testified that she visited a few colleges and vocational schools and attended lectures given by professors at the University of Israel. With respect to the lectures petitioner allegedly attended, we note that she could not remember the names of the lecturers or the specific nature of the lecture topics. This does not surprise us given the fact that petitioner did not keep a diary or journal of her activities while in Israel, Egypt and Spain.

We find that petitioner has fallen way short of establishing that her participation in the fashion study course maintained or improved her skills as a guidance counselor. While traveling is broadening, culturally enriching, and may add to one's

BEST COPY AVAILABLE

sensitivity to, and understanding of, others,[4] there simply was no showing that the travel undertaken pursuant to the fashion study course bore a direct and proximate relationship to petitioner's activities as a guidance counselor to convert what normally is a personal expense into a business expense.[5] To reflect the parties' concessions and the foregoing,

Decision will be entered under Rule 155.

---

4 Baker v. Commissioner, T.C. Memo. 1973-206.

5 Having found that the threshold requirements of sec. 1.162-5(a), Income Tax Regs., were not met by petitioner, we need not address respondent's alternative arguments that the requirements of sec. 1.162-5(d), Income Tax Regs., and the substantiation requirements of sec. 274 were not satisfied by petitioner.

BEST COPY AVAILABLE

COMPLETED

Dec 11,262; 1986-371

T. C. Memo. 1986-371

ORIGINAL

UNITED STATES TAX COURT

JOHN E. KENNY and EDNA M. KENNY, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23808-84. Filed August 11, 1986.

John E. Kenny and Edna M. Kenny, pro se.

Miles D. Friedman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: This case was assigned to Special Trial Judge Marvin F. Peterson pursuant to section 7456 and Rules 180, 181 and 183.[1] The Court agrees with and adopts his opinion, which is set forth below.

---

1 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

OPINION OF THE SPECIAL TRIAL JUDGE

PETERSON, Special Trial Judge: Respondent determined deficiencies and additions to tax in petitioners' Federal income taxes as follows:

Year	Deficiency	Addition to Tax Sec. 6653(b)
1974	$28,879.98	$14,439.99
1975	3,878.19	1,939.10

After concessions by both parties, including the section 6653(b) additions to tax for fraud, the remaining issues for our decision are:

1. Whether respondent is estopped from determining a deficiency in petitioners' 1974 Federal income tax based upon unreported income in excess of $12,871.72;[2] and

2. Whether petitioner Edna M. Kenny is an "innocent spouse" entitled to relief under section 6013(e).

As to the section 6653(b) additions to tax, petitioner John E. Kenny concedes the addition to tax for 1975 and that he is liable for the addition to tax for 1974 to the extent it applies to the correct amount of the underpayment for such year; respondent concedes that petitioner Edna M. Kenny is not liable for the section 6653(b) additions to tax for either year.

---

[2] The deficiency in petitioners' 1974 income tax as determined by respondent is based upon unreported income in the amount of $76,639.07.

BEST COPY AVAILABLE

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in San Diego, California, at the time the petition in this case was filed.

Collateral Estoppel

Petitioner John E. Kenny (hereinafter petitioner) was convicted during 1979 on 14 counts of a 16-count Federal indictment, including seven counts of presenting false claims to the United States in violation of 18 U.S.C. sec. 287 (1948) and two counts of income tax evasion under section 7201 for 1974 and 1975.[3] During 1981 the United States brought a civil complaint (hereinafter referred to as the civil action) against petitioner in the United States District Court for the Southern District of California seeking recovery under the False Claims Act, 31 U.S.C. secs. 231-235, R.S. secs. 3490-3494, 5438 (2d ed. 1878),[4] and asserting additional and alternative grounds of recovery for fraud and for recoupment of public funds mistakenly paid. The

---

[3] Petitioner's convictions on all 14 counts were affirmed on appeal. United States v. Kenny, 645 F.2d 1323 (9th Cir. 1981).

[4] At the time the United States brought the civil action against petitioner, Title 31 of the United States Code had not yet been enacted into positive law. The civil provisions of the False Claims Act, with certain nonsubstantive modifications, have since been reenacted into positive law. Act of Sept. 13, 1982, Pub. L. 97-258, 96 Stat. 877, 978 and 979, 31 U.S.C. secs. 3729-3731. See also Defense Procurement Improvement Act of 1985, Pub. L. 99-145, Title IX, sec. 931(b), 99 Stat. 682, 699, supplementing 31 U.S.C. sec. 3729 (1982). For a brief history of the False Claims Act prior to 1976, see United States v. Bornstein, 423 U.S. 303, 305 n. 1 (1976).

BEST COPY AVAILABLE

civil action was based on the same matters which had been the subject of the criminal case which resulted in petitioner's conviction.

In the civil action the United States filed a Motion for Partial Summary Judgment in which it sought recovery with respect to seven invoices totaling $12,871.72. In its motion the United States alleged that each of such seven invoices corresponded to the smallest invoice upon which petitioner could have been convicted in the criminal case with respect to each of the seven counts of the indictment for presentation of false claims.[5] The United States' Motion for Partial Summary Judgment was granted and, since the United States did not pursue the case further, it became the basis for the final judgment in the civil action, entered November 23, 1981.

As stated in footnote 2, respondent determined that petitioner failed to report income received pursuant to false claims against the Government, in the total amount of $76,639.07 for 1974. Petitioner asserts that the judgment in the civil action conclusively establishes $12,871.72 as the maximum amount which he could have received in connection with the presentation of false claims, and that respondent is thereby estopped from determining that he received additional amounts from the filing of false claims during 1974. We disagree.

---

[5] All but one of such seven counts involved multiple invoices.

BEST COPY AVAILABLE

Under collateral estoppel, once a court of competent jurisdiction has decided an issue of fact or law necessary to its judgment, redetermination of such issue may be precluded in a subsequent suit on a different cause of action involving a party to the first case. Montana v. United States, 440 U.S. 147, 153 (1979); Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979). The prior judgment, however, operates as an estoppel only as to those issues and points actually controverted, the determination of which were necessary to the finding or verdict rendered. Commissioner v. Sunnen, 333 U.S. 591, 598 (1948); Cromwell v. County of Sac, 94 U.S. 351, 353 (1876). Moreover, collateral estoppel does not apply with respect to any issue which the party against whom it is asserted did not have a "full and fair opportunity" to litigate in the earlier case. Allen v. McCurry, 449 U.S. 90, 95 (1980).

The judgment in the civil action established that petitioner was civilly liable for false claims amounting to $12,871.72. However, respondent is not estopped from determining that petitioner received additional amounts of income in connection with the filing of false claims not actually litigated in the civil action. Commissioner v. Sunnen, supra; Cromwell v. County of Sac, supra. It is clear that the judgment of the district court in the civil action was based solely upon the sums placed in issue by the United States in its Motion for Partial Summary Judgment, and that the parties to that action did not litigate any further amounts. Where, as here, the cause of action is

BEST COPY AVAILABLE

different from that litigated in the earlier action, the parties are not barred from asserting issues of law or fact not actually decided in the first case. Montana v. United States, supra; Parklane Hosiery Co. v. Shore, supra. Therefore, the judgment in the civil action does not estop respondent from determining that petitioner received additional amounts of income from presenting false claims during 1974.

We also reject petitioner's contention that the combined effect of the judgments in the criminal and civil cases somehow estops respondent in the instant case. Petitioner asserts that he was convicted of filing false claims in the amount of $12,871.72 (an amount which he contends was established by the judgment in the civil case) and that respondent is thereby estopped from determining that a greater amount was received from presenting false claims. However, even if we were to assume that petitioner was acquitted with respect to all other false invoices raised in the indictment, it has long been settled that acquittal of a criminal charge does not bar the Government in a subsequent civil action arising out of the very facts on which the criminal proceeding was based.[6] Murphy v. United States, 272 U.S. 630, 631-632 (1926); Stone v. United States, 167 U.S. 178, 188 (1897).

---

[6] This is due to the difference in the burden of proof required in criminal and civil cases. An acquittal is "merely * * * an adjudication that the proof was not sufficient to overcome all reasonable doubt of the guilt of the accused," Lewis v. Frick, 233 U.S. 291, 302 (1914), but it does not foreclose the possibility that the same facts could be established in a civil proceeding under the less stringent burden of proof in civil cases.

BEST COPY AVAILABLE

Moreover, the judgment of petitioner's conviction does not purport to deal with any false claims not pleaded in the indictment and thus cannot serve to estop respondent from determining that other false claims resulted in income to petitioner during 1974. Fox v. Commissioner, 61 T.C. 704, 711 (1974). Accordingly, we reject petitioner's estoppel argument and sustain respondent's determination.

Innocent Spouse

Petitioners assert that petitioner Edna M. Kenny (Edna) is an "innocent spouse" and that pursuant to section 6013(e) she should, therefore, be relieved of any liability for tax with respect to the income from false claims which her husband failed to report on their joint returns for 1974 and 1975. In order to avail herself of the relief afforded by section 6013(e), Edna must establish, inter alia, that in signing the joint returns for the years in issue she did not know, and had no reason to know, that such returns contained substantial understatements of tax.[7] Section 6013(e)(1)(C). Further, taking into account all the facts and circumstances, we must find that it is inequitable to hold her liable for the deficiencies in tax for such years to the extent they are attributable to such substantial understatements. Section 6013(e)(1)(D). Petitioners bear the burden of proof on this issue. Rule 142(a).

---

[7] Petitioners' tax returns for both years in issue clearly contained substantial understatements within the meaning of sec. 6013(e)(3). See sec. 6661(b)(2)(A).

BEST COPY AVAILABLE

Petitioners have offered no evidence with respect to Edna's claim as an "innocent spouse." Edna did not testify at trial, and the record does not reflect any facts from which it can be determined whether or not Edna satisfies the requirements contained in sections 6013(e)(1)(C) and (D). We, therefore, hold that Edna is not entitled to relief as provided under section 6013(e). Rule 142(a).

In order to take into account concessions made by both parties,

Decision will be entered under Rule 155.

BEST COPY AVAILABLE

COMPLETED
14
AUG 19 1986

Jul 11.7/2: 1986-372

T-211

T. C. Memo. 1986-372

ORIGINAL

UNITED STATES TAX COURT

DON AND RITA CHARLESTON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

DON CHARLESTON & CO., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 14999-84, 15000-84. Filed August 11, 1986.

Mark Charleston, for the petitioners.

Evelyn M. Zeller, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent determined deficiencies in petitioners' taxable years 1979, 1980 and 1981. These consolidated cases concern petitioners Don and Rita Charleston and an incorporated accounting practice known as Don Charleston & Co. In separate statutory notices of deficiency dated March 5,

BEST COPY AVAILABLE

1984, respondent determined income tax deficiencies for the 3 taxable years, as follows:

	1979	1980	1981
Don and Rita Charleston	$2,097	$1,147	$1,694
Don Charleston & Co.	$1,541	$1,564	$1,388

The deficiencies are attributable solely to the disallowance of claimed amortization of a customer list by the corporate taxpayer and the inclusion of constructive dividends to the individuals in connection with payments made to Don Charleston's parents for acquisition of his accounting practice. The issues presented for our consideration are: (1) Whether petitioner acquired the customer list of an accounting business or whether a going concern, including goodwill, was acquired; (2) if all or part of the acquisition constitutes a customer list, whether that list had an indefinite useful life so that its cost was not depreciable; and (3) whether payments made by the corporate petitioner to the individual petitioner's parents for the purchase of an accounting practice constitute constructive dividends.

FINDINGS OF FACT

Petitioners Don and Rita Charleston resided in Melrose Park, Pennsylvania, at the time of filing their petition in this case. Petitioner Rita Charleston is a party to this proceeding only by reason of filing joint Federal income tax returns with Don

BEST COPY AVAILABLE

Charleston for the taxable years 1979 through 1981. Petitioner Don Charleston & Co. (Corporation) had its principal place of business in Melrose Park, Pennsylvania, at the time it filed its petition herein.

Petitioner Don Charleston (Don) is a certified public accountant and began his accounting career in 1955 working for his father. Don's father, Abe Charleston (Abe), operated an individual proprietorship which conducted a bookkeeping and tax service under the name of Charleston Audit and Tax Service up until 1964. Abe was not a certified public accountant. Essentially, Abe maintained books and performed "write up" work in single-entry form for small individual proprietors. Additionally, Abe assisted his clientele in the preparation of their tax returns. Abe did not keep any general ledgers or prepare financial statements for his customers.

Abe singularly conducted a bookkeeping and tax service until 1955 when his son, Don, joined him as an employee. Don worked for his father for 9 years until his father's retirement in mid-1964. During that period, Don became familiar with his father's practice and was known to the clients. In 1964, at a time when Abe's business had 119 customers, Don entered into an oral understanding with his father. Although some memorandum of the understanding had been prepared, petitioners were unable to produce the memorandum. Don was to pay $100 a week for the remainder of Abe's life. If the net profit of the accounting

BEST COPY AVAILABLE

practice exceeded $30,000 for 2 consecutive years, Don was to pay an additional $100 a week to his father. When Abe died, if Don's mother was still alive, she was to receive a maximum of $100 per week.

In exchange for those payments, Don became entitled to the bookkeeping and tax service practice. The gross income of the business for 1964 was $47,200 and the net income was approximately $17,000. Pursuant to the understanding, Don paid his father $100 a week beginning in 1964 through the end of 1972. Beginning in 1973, Corporation paid Abe $200 a week through July of 1978 when Abe died. Thereafter, Corporation paid Don's mother $100 a week until she died on September 6, 1981. Don and Corporation paid Don's parents a total of $118,500 during the period beginning mid-1964 through September of 1981.

During 1964 when Abe retired, Don acquired all of the files, records, office furnishings, office equipment and the lease to the business premises. Don continued the business as a sole proprietor supplying bookkeeping, accounting and tax services to the existing clients beginning in mid-1964. Don no longer used the business name of Charleston Audit and Tax Service and began using the name Don Charleston, C.P.A., instead. In 1972, Don incorporated his sole proprietorship and began using Don Charleston & Co. as the corporate business name. Upon the retirement of Abe, Don continued to employ the same secretaries and did not notify the clients of the change in ownership.

BEST COPY AVAILABLE

Although Don and Abe had negotiated concerning Don's takeover of the accounting service, no allocation of value had been made among the assets Don acquired from his father. At the time of Don's takeover, his father was 63 years old and his mother was 62 years old.[1] Don believed that their life expectancy was no more than 8 to 10 years because they suffered from coronary arteries disease and because of their family medical histories. Accordingly, Don expected to pay approximately $52,000 ($5,200 per year for 10 years) for the accounting practice.

Don did not claim any amortization with respect to the 1964 client list that he acquired from the period beginning 1964 through 1976. In 1977, for the first time, Don Charleston & Co. claimed amortization of the client list which had been acquired in 1964. The amortization deduction claimed for 1977 was $9,640 which was computed by applying a 10-percent rate to the cumulative total of payments which had been made to Abe from 1964 through 1977 ($96,400). Similarly for taxable years 1979, 1980 and 1981, the Corporation claimed amortization in the amount of 10 percent of the adjusted total of the payments made to Don's parents. The adjusted total was computed by adding all payments made up to the point of the claimed amortization and deducting

---

[1] The parties have stipulated for purposes of this case that as of mid-1964 the standard tables reflected a life expectancy for Don's father and mother of 13.6 years and 17.8 years, respectively.

BEST COPY AVAILABLE

the accumulated amortization from prior years. The amounts so claimed for the years in issue are: $9,066 for 1979, $8,680 for 1980 and $8,162 for 1981.

The Corporation's returns reflect in Schedule L (the balance sheet), under other assets, an amount each year for the "cost of purchased accounts." No amount is reflected in the corporate tax return balance sheets regarding a liability for payments to Don's parents pursuant to the 1964 understanding. Up until 1977, Don and the Corporation had lost less than 5 of the original 119 customers acquired in 1964. Don testified, in an effort to explain why amortization had not begun until 1977, that the customer loss experience increased to 10 or 11 during 1977.

The fair market value of a small professional business during 1964 could be expected to be in a range of 1 to 1.5 times the gross revenues of the business. Considering $100 level weekly payments for 17.8 years (the longest of the two life expectancies), the overall payments for the accounting business would have totaled $92,900. The discounted present value would have been rounded to approximately $56,000. A $56,000 present interest during 1964 would have approximated 1.2 times the business' gross revenues for that year ($47,200).

BEST COPY AVAILABLE

OPINION

Section 167(a)[2] provides for an amortization or depreciation deduction on property used in business or held for the production of income. Section 1.167(a)-3, Income Tax Regs., is a long-standing[3] refinement of the general rule as it applies to "intangibles." In pertinent part, section 1.167(a)-3, Income Tax Regs., provides as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. * * * An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to the goodwill. * * *

The controversy of the parties centers on whether a customer list was purchased or whether, as respondent contends, a going concern, including goodwill, was acquired. If we decide this question in petitioners' favor, then petitioners have the burden of showing that the intangible asset has a limited useful life of ascertainable duration. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240, 1246 (5th Cir. 1973); Manhattan Co. of Virginia, Inc. v. Commissioner, 50 T.C. 78, 87-88 (1968);

---

2 All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

3 Originally, sec. 1.167(a)-3, Income Tax Regs., was part of T.D. 6182, 1956-1 C.B. 98, and it was republished in T.D. 6500, filed Nov. 25, 1960. See 1960-2 C.B. VII.

BEST COPY AVAILABLE

Misegades v. Commissioner, 53 T. C. 477, 484-485 (1969). If any portion of the acquisition is attributable to goodwill, that part is not amortizable. Sec. 1.167(a)-3, Income Tax Regs.; Houston Chronicle Publishing Co. v. United States, supra at 1247.

The general rule is that acquisition of a professional practice is the acquisition of an intangible capital asset in the nature of goodwill. Misegades v. Commissioner, supra at 485 (a lawyer), Boe v. Commissioner, 35 T.C. 720, 724-725 (1961), affd. 307 F.2d 339 (9th Cir. 1962) (a doctor); Butler v. Commissioner, 46 T.C. 280 (1966) (an accountant); Brooks v. Commissioner, 36 T.C. 1128 (1961) (a dentist).

"Goodwill," in the context of intangible assets (subscription lists), similar to those in this case, was effectively expounded upon in Houston Chronicle Publishing Co. v. United States, supra at 1247, as follows:

> "[T]he nature of goodwill * * * is the expectancy that 'the old customers will resort to the old place.' Commissioner of Internal Revenue v. Killian, 314 F.2d 852, 855 (C.A.5, 1963); Nelson Weaver Realty Co. v. Commissioner of Internal Revenue, 307 F.2d 897, 901 (C.A.5, 1962); Karan v. Commissioner of Internal Revenue, 319 F.2d 303, 306 (C.A.7, 1963). '[T]he essence of goodwill is the expectancy of continued patronage, for whatever reason.' Boe v. Commissioner of Internal Revenue, 307 F.2d 339, 343 (C.A.9, 1962) * * *. [T]o the extent [a given item or asset] contributes to the expectancy that the old customers will resort to the old place it is an element of goodwill. Commissioner of Internal Revenue v. Seaboard Finance Co., 367 F.2d 646, 651 n. 6 (C.A.9, 1966); Boe v. Commissioner of Internal Revenue, supra, 307 F.2d at 343.

BEST COPY AVAILABLE

"* * *

> "This Court has held that * * * goodwill is acquired by the purchaser of a going concern where the 'transfer enables the purchaser to step into the shoes of the seller.' Balthrope v. Commissioner of Internal Revenue, 356 F.2d 28, 32 n. 1 ([C.A.5] 1966); Masquelette's Estate v. Commissioner of Internal Revenue, 239 F.2d 322, 325 ([C.A.5] 1956). We have also said that goodwill is transferred where, as here, the buyer continues the seller's business uninterrupted, using primarily the seller's employees, and utilizing the seller's name. Barran v. Commissioner of Internal Revenue, supra, 334 F.2d 58, 61 ([C.A.5] 1964). It is immaterial that the agreement did not use the term 'goodwill,' for '[t]he use of these words is, of course, not necessary if in fact what is transferred does give to the purchaser everything that can effectively aid him to step into the shoes of the seller.' Masquelette's Estate v. Commissioner of Internal Revenue, supra, at 325; see also Barron v. Commissioner of Internal Revenue, supra, at 61 * * *."

Don testified and now argues in his brief that his only intent was to buy the customer list and that, accordingly, the entire purchase price should be allocated to that asset. The record in this case simply does not support petitioners' contentions. We must agree with respondent that Don purchased a professional practice from his father. A number of factors have led us to this ultimate finding of fact. Don did not separate the customer list and utilize it in another business, as was done in Manhattan Co. of Virginia, Inc. v. Commissioner, supra; National Service Industries, Inc. v. United States, 379 F. Supp. 831 (N.D. Ga. 1973); or Holden Fuel Oil Co. v. Commissioner, T.C. Memo. 1972-45. Here, Don merely stepped into his father's practice. The same office, secretaries, office equipment,

BEST COPY AVAIL

fixtures and customer records were utilized by Don. No announcement concerning the new ownership was made to the 119 customers. Ostensibly, such an announcement might have affected the clients' continued patronage. The transition in this setting was nominal because Don had worked in his father's business for 9 years before the acquisition and had developed a working rapport with clients. This is evidenced by their continued patronage reflected in the nominal reduction of the 119 customers for the 14 years preceding the first taxable year in issue. We find it incredible that Don would need to purchase a customer list composed of the very individuals and businesses he had helped to service for 9 years.

We find this case no different from Misegades v. Commissioner, supra, and others where there is an acquisition of a professional practice which constitutes an intangible asset in the nature of goodwill. The customer list in this case is so inextricably linked with goodwill that it cannot be considered separately from the goodwill of the accounting or bookkeeping practice acquired. Marsh & McLennan, Inc. v. Commissioner, 51 T.C. 56, 64 (1968), affd. 420 F.2d 667, 668 (3d Cir. 1969). Accordingly, Corporation is not entitled to a deduction for amortization of the customer list for the taxable years 1979, 1980 and 1981.

BEST COPY AVAILABLE

Having found that Don acquired a non-dep reciable or non-amortizable intangible asset, there is no need to consider or decide whether petitioners have carried their burden of showing that the "customer list" had a limited useful life of ascertainable duration;[4] the depreciable basis of the asset; or whether the respondent's regulation concerning depreciation that is "allowed or allowable" is valid or "unconstitutional," as petitioners contend.

The remaining issue for our consideration is whether the $100 weekly payments made by Corporation to Don's mother are taxable to Don as constructive dividends. The existence of a constructive dividend is conceptually gauged by whether "the corporation conferred an economic benefit on the stockholder without the expectation of repayment." Gibbs v. Tomlinson, 362 F.2d 394, 397 (5th Cir. 1966); Sullivan v. United States, 363 F.2d 724, 728 (8th Cir. 1966); Hash v. Commissioner, 273 F.2d 248, 250 (4th Cir. 1959).

The parties have provided us with a very limited briefing of this point with respect to the facts and law. Respondent has cited two "boilerplate" constructive dividend cases and supplied the proposed finding of fact that Corporation's return does not reflect assumption of the liability to Don's parents. Petitioners simply contended that whether we find that goodwill,

---

[4] In any event, petitioners did not present sufficient evidence to carry this burden or properly explain why depreciation was not claimed and/or ascertainable from the outset in 1964.

BEST COPY AVAILABLE

a going business or a customer list was acquired, the purchase of a business asset was being completed by the $100 weekly payments made during the taxable years before us. To this extent petitioners are correct and respondent has not contended or denied that there was not an arm's-length purchase by Don from Abe. The crucial question we must determine is whether the payments were for Don's benefit.

Essentially, if a corporate entity makes a payment for a shareholder's personal benefit, a constructive dividend may have occurred. There are numerous cases where payments were made on personal obligations of shareholders. E.g., see Challenge Manufacturing Co. v. Commissioner, 37 T.C. 650, 663 (1962); and Falsetti v. Commissioner, 85 T.C. 332, 356-357 (1985). Here we have decided that no deduction is allowable to the Corporation for depreciation or amortization of the goodwill acquired. The fact that a corporation is not entitled to a deduction in connection with a payment, does not automatically result in a constructive dividend to a shareholder(s). Palo Alto Town and Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1391 (9th Cir. 1977). That principle is especially cogent in a situation where, as here, there is a business purpose for the payments. Although, as respondent points out, no liability for payment of the weekly accounts to Don's parents was reflected on the

BEST COPY AVAILABLE

corporate return, the "list of purchased clients" was reflected in various increasing amounts, beginning with $39,200 for the 1972 year.

The U. S. Corporation Income Tax Return, Form 1120, for Corporation's initial year (1972), in composite, reveals that the tangible and intangible assets of the accounting practice were transferred by Don to Corporation. The absence of an entry for the future obligations to Don's parents may have been an oversight or an accounting judgment as to its includibility. We have difficulty accepting the respondent's assumption that Don retained the liability but transferred the intangible asset which, at that time, represented the "goodwill" of nearly 119 clients. We cannot allow respondent to separate the obligation to pay from the ownership of the asset and the payor of the obligation under these circumstances. The payments to acquire the already incorporated assets are clearly a business need of the corporate entity. If these payments were merely support payments to Don's parents, we would likely reach a different conclusion.

BEST COPY AVAILABLE

We find that the payments herein did not inure directly to Don's benefit, but instead were payments clearly connected with the conduct of Corporation's business activity.

To reflect the foregoing,

Decision will be entered for petitioners in docket No. 14999-84.

Decision will be entered for respondent in docket No. 15000-84.

BEST COPY AVAILABLE

JCU 11.7/2:1986-373

COMPLETED
6

mk 2-11

T. C. Memo. 1986-373

ORIGINAL

UNITED STATES TAX COURT

PETER D. and BARBARA J. BEAUMONT, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19110-85. Filed August 11, 1986.

Peter D. and Barbara J. Beaumont, pro se.

Bernard P. Coniff, counsel for respondent.

MEMORANDUM OPINION

SWIFT, Judge: This matter is before the Court on respondent's motion to dismiss as to petitioner, Barbara J. Beaumont. For the reasons stated, respondent's motion will be denied.

A joint statutory notice of deficiency dated April 9, 1985, was sent by certified mail to Peter Beaumont and Barbara Beaumont at their last known address, P.O. Box 95-3145, Stuart, Florida 33495, on April 9, 1985. Determined therein were deficiencies in

BEST COPY AVAILABLE

petitioners' joint Federal income tax liabilities for 1981 and 1982 in the respective amounts of $105,582.13 and $38,163.90, plus certain additions to tax.

On June 17, 1985, the Court received a letter signed only by petitioner Peter Beaumont requesting further information from the Court on how to file a petition. This letter was accepted as a petition to which docket No. 19110-85 was assigned. On June 27, 1985, the Court issued its Order For Proper Petition and Filing Fee to petitioner Peter Beaumont allowing him until August 27, 1985, to file an amended petition and to pay the filing fee.

The 90-day period for timely filing a petition with the Court with respect to the notice of deficiency expired on July 8, 1985. On August 27, 1985, the Court received an amended petition in this docket. The amended petition, however, purported to be from Peter D. and Barbara J. Beaumont.

Respondent argues that the amended petition, filed on August 27, 1985, was the first and only petition filed by Barbara J. Beaumont in this docketed case. Because August 27, 1985, is 140 days after the date of mailing of the notice of deficiency, respondent argues that Barbara J. Beaumont did not file with the Court a timely petition within the time prescribed by sections 6213(a) or 7502.[1]

---

[1] All section references are to the Internal Revenue Code of 1954, and all rule references are to the Tax Court Rules of Practice and Procedure.

BEST COPY AVAILABLE

Rule 34 describes in detail the information which is required to be included in a timely and proper petition with the Court.[2] The Court, however, clearly is not required to dismiss an improper petition. The Note to Rule 34(a) indicates that--

---

2 Rules 34(a) and (b) provide in pertinent part as follows:

> **(a) General:** (1) Deficiency or Liability Actions: * * * Where the notice of deficiency or liability is directed to more than one person, each such person desiring to contest it shall file a petition on his own behalf, either separately or jointly with any such other person, and each such person must satisfy all the requirements of this Rule with respect to himself in order for the petition to be treated as filed by or for him. The petition shall be complete, so as to enable ascertainment of the issues intended to be presented. No telegram, cablegram, radiogram, telephone call, or similar communication will be recognized as a petition. Failure to the petition to satisfy applicable requirements may be ground for dismissal of the case. As to the joinder of parties, see Rule 61; and as to the effect of misjoinder of parties, see Rule 62.
>
> **(b) Content of Petition in Deficiency or Liability Actions:** The petition in a deficiency or liability action shall contain * * *:
>
> (1) The petitioner's name and legal residence, in the case of a petitioner other than a corporation; in the case of a corporate petitioner, its name and principal place of business or principal office or agency; and, in all cases, the petitioner's identification number (e.g., Social Security number or employer identification number) and the office of the Internal Revenue Service with which the tax return for the period in controversy was filed. The legal residence, principal place of business, or principal office or agency shall be stated as of the date of filing the petition. In the event of a variance between the name set forth in the notice of deficiency or liability and the correct name, a statement of the reasons for such variance shall be set forth in the petition.
>
> (2) The date of the notice of deficiency or liability, or other proper allegations showing

(footnote continued)

BEST COPY AVAILABLE

The dismissal of a petition, for failure to satisfy applicable requirements, depends on the nature of the defect, and therefore is put in the contingent "may" rather than the mandatory "shall." * * *

(footnote continued from previous page)
jurisdiction in the Court, and the City and State of the office of the Internal Revenue Service which issued the notice.

(3) The amount of the deficiency or liability, as the case may be, determined by the Commissioner; the nature of the tax; the year or years or other periods for which the determination was made; and, if different from the Commissioner's determination, the approximate amount of taxes in controversy.

(4) Clear and concise assignments of each and every error which the petitioner alleges to have been committed by the Commissioner in the determination of the deficiency or liability. The assignments of error shall include issues in respect of which the burden of proof is on the Commissioner. Any issue not raised in the assignment of errors shall be deemed to be conceded. Each assignment of error shall be separately lettered.

(5) Clear and concise lettered statements of the facts on which petitioner bases the assignments of error, except with respect to those assignments of error as to which the burden of proof is on the Commissioner.

(6) A prayer setting forth relief sought by the petitioner.

(7) The signature of each petitioner or his counsel.

(8) A copy of the notice of deficiency or liability, as the case may be, which shall be appended to the petition, and with which there shall be included so much of any statement accompanying the notice as is material to the issues raised by the assignments of error. If the notice of deficiency or liability or accompanying statement incorporates by reference any prior notices, or other material furnished by the Internal Revenue Service, such parts thereof as are material to the issues raised by the assignments of error likewise shall be appended to the petition.

BEST COPY AVAILABLE

In this same regard, Rule 60(a) provides in part as follows:

> A case timely brought shall not be dismissed on the ground that it is not properly brought on behalf of a party until a reasonable time has been allowed after objection for ratification by such party of the bringing of the case; and such ratification shall have the same effect as if the case had been properly brought by such party. * * *

The Court herein treated the letter signed by petitioner Peter D. Beaumont as a timely petition. The only question before us is whether that letter is to be regarded as the petition only of Peter D. Beaumont or also of his wife, Barbara J. Beaumont. Initially, it was treated by the Court only as the petition of Peter, as evidenced by the Court's order of June 27, 1985, which made no mention of Barbara. Petitioners, however, treated the improper petition as conferring jurisdiction in this Court over each of them, and they joined in filing the amended petition on August 27, 1985.

In Holt v. Commissioner, a Court-reviewed opinion, 67 T.C. 829 (1977), a letter that was signed only by one spouse was treated by the Court as a petition also of the other spouse because the attachment to the letter (namely, the joint notice of deficiency) referred to both spouses. Reference to both spouses in the attachment to the letter and in the joint amended petition was considered sufficient to establish the intent of the taxpayers therein to file a joint petition. We held in Holt that

BEST COPY AVAILABLE

the taxpayer-husband "was acting as agent for his wife as well as for himself in filing such imperfect petition in response to the joint notice of deficiency." 67 T.C. at 832.

The Court also stated in Holt that "the spouse who did not sign the imperfect petition should be given the opportunity to confirm the correctness of that presumption of intent," and the Court expressed in a footnote the hope that with the enunciation of "this practical, workable, and fair rule the Commissioner should no longer find it necessary to move against a previously nonsigning spouse, thus avoiding needless administrative burdens and the cluttering of the Court's motions calendar." 67 T.C. at 833. Respondent's counsel herein, by filing the instant motion, did not follow the spirit of Holt, nor did he cite the Holt opinion in his moving papers.

The letter petitioner Peter D. Beaumont mailed to the Court made it quite clear that it was mailed on behalf of both himself and his wife. The letter used the plural pronoun "we." It stated that "we just received a 90 day letter," and it requested that certain information be sent so that "we can use" it.

On the authority of Holt, under the facts of this case, we deny respondent's motion. The letter received on June 17, 1985, will be regarded as a timely petition, albeit imperfect, of both petitioners herein.

An appropriate order will be issued.

BEST COPY AVAILABLE

Jul 11.7/2:1986-374

T. C. Memo. 1986-374

ORIGINAL

UNITED STATES TAX COURT

RALPH R. DeVILLARS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15656-85. Filed August 12, 1986.

Held, by failing to make a timely response to a Request for Admissions served upon petitioner and filed with the Court by respondent in the manner provided by Rule 90, Tax Court Rules of Practice and Procedure, and by showing no basis upon which the matters thereby deemed admitted under the Rule should be modified or withdrawn, and the matters contained in the Request for Admissions being comprehensive as to all matters contained in respondent's determination of deficiencies in income tax and additions to tax upon which petitioner has the burden of proof, petitioner has accordingly admitted the correctness of respondent's determination in all respects.

Ralph R. DeVillars, pro se.

Russell F. Kurdys and Edward J. Laubach, Jr., for the respondent.

BEST COPY AVAILABLE

MEMORANDUM OPINION

NIMS, Judge: This case is before the Court on respondent's Motion for Summary Judgment filed April 2, 1986, for a decision in the total amount of the deficiencies in income tax and additions to tax determined by respondent in a deficiency notice sent to petitioner on March 6, 1985. Rule 121, Tax Court Rules of Practice and Procedure. Respondent determined the following deficiencies:

		Additions to Tax		
Tax Year Ended	Deficiency	Sec. 6651(a)(1)[1]	Sec. 6653(a)(1)	Sec. 6654(a)
December 31, 1977	$ 6,391.50	$1,597.88	$319.58	$227.68
December 31, 1978	11,586.70	2,896.68	579.34	369.88
December 31, 1979	16,008.90	4,002.23	800.45	669.21
December 31, 1980	5,497.28	1,374.32	274.86	350.26

Respondent's motion is based entirely upon facts deemed admitted by petitioner as a result of his failure to make a timely response to respondent's Request for Admissions (the Request) served by mail upon petitioner on February 20, 1986, and filed with the Court on February 24, 1986. At a hearing on this matter petitioner admitted the correctness of the address to which the Request was mailed, although in a previous document he had denied receiving same. We hold that the Request for Admissions was properly served and filed in compliance with Rule 90.

---

[1] Unless otherwise noted, all section references are to sections of the Internal Revenue Code of 1954 in effect for the years in question. All rule references are to the Tax Court Rules of Practice and Procedure.

Although Rule 90(c) requires a response within 30 days after service of a request for admissions, no response was forthcoming from petitioner until May 2, 1986, a date subsequent to the date on which respondent filed his Motion for Summary Judgment and 71 days after service of the Request. Under Rule 90(c), each matter is deemed admitted in the absence of an adequate response within the aforementioned 30-day period.

The petition in this case raises Fifth Amendment objections, as exemplified by the following paragraphs:

> C. Petitioner has validly claimed his right against self-incrimination as grounds for refusing to produce the financial information demanded of him by The Internal Revenue Service, has requested a grant of immunity as provided by law, and indicated his willingness to supply the financial information demanded of him provided he is granted immunity against its use against him in a later prosecution.
>
> D. Petitioner is not unwilling to assume the burden of proof at Tax Court if the Court can secure for him a grant of immunity; but, in the absence of a grant of immunity Petitioner alleges that placing the burden of proof on him would constitute unlawful coercion, compulsion, and infliction of penalties to compel potentially incriminating information which has not been immunized.

The facts contained in respondent's Request which are deemed admitted are as follows:

1. For each of the years 1977, 1978, 1979 and 1980 petitioner Ralph R. DeVillars, without reasonable cause, did not file Federal income tax returns. Said failure to file continues to date.

2. During the years 1977, 1978, 1979 and 1980, Ralph DeVillars had gross income from business in the following amounts:

1977	$ 35,224.62
1978	44,156.43
1979	50,035.37
1980	27,198.49

3. During those years, petitioner's cost of goods sold were as follows:

1977	$4,072.13
1978	2,166.54
1979	3,101.74
1980	1,301.03

4. During those years, petitioner had deductible business expenses from his sales activities as follows:

1977	$5,349.33
1978	6,160.00
1979	5,456.60
1980	6,017.51

5. During those years, petitioner had interest income in the following amounts:

1977	$ 20.87
1978	133.59
1979	129.21
1980	--

6. During the years in issue, petitioner had deductible alimony expenses as follows:

1977	$ - 0 -
1978	1,500.00
1979	1,800.00
1980	1,800.00

7. During the years in issue, petitioner had deductible itemized deductions as follows:

1977	$ 1,863.96
1978	--
1979	--
1980	--

8. Petitioner's correct taxable income for those taxable years are as follows:

1977	$22,460.07
1978	32,963.48
1979	38,806.24
1980	18,079.95 (tax table income)

9. For these years, petitioner's correct income tax is as follows:

1977	$ 6,391.50
1978	11,586.70
1979	16,008.90
1980	5,497.28

10. For 1977, 1978, 1979 and 1980, petitioner filed no Federal income tax return, and no assessments or payments in tax were made by petitioner for any of those years.

11. The deficiencies in tax due from petitioner for the years in question are as follows:

1977	$ 6,391.50
1978	11,586.70
1979	16,008.90
1980	5,497.28

12. Since petitioner, without reasonable cause, failed to file tax returns, there are additions to the tax due for the taxable years 1977, 1978, 1979 and 1980 under I.R.C. sec. 6651(a)(1) in the amounts of $1,597.88, $2,896.68, $4,002.23 and $1,374.32, respectively.

BEST COPY AVAILABLE

13. Part of the underpayment of tax for the taxable years 1977, 1978, 1979 and 1980 is due to negligence or intentional disregard to the rules and regulations by petitioner. Consequently, the 5 percent addition to the tax under I.R.C. sec. 6653(a)(1) is applicable.

14. There are due from petitioner for the taxable years 1977, 1978, 1979 and 1980 additions to the tax under I.R.C. sec. 6653(a)(1) in the following amounts:

1977	$319.58
1978	579.34
1979	800.45
1980	274.86

15. Petitioner underpaid his estimated tax for each of the years, and consequently is liable for the additions to the tax under I.R.C. sec. 6654(a) in the following amounts:

1977	$227.68
1978	369.88
1979	669.21
1980	350.26

Petitioner's late response to respondent's Request for Admissions was as follows:

1. Untrue, for the years 1977, 1978, 1979, and 1980. Petitioner Ralph R. DeVillars was not required to file Federal tax returns due to lack of income, Connors v. U.S., Civ. A No. 68H721.

2. Untrue, for the years 1977, 1978, 1979, and 1980. Ralph DeVillars had no gross income, but compensation for labor in exchange for time.

3. Denied, blatant understatement of costs.

4. Denied, blatant understatement of expenses.

5. Denied.

6. Denied, blatant understatement of expenses of raising a child.

7. Denied.

8. Untrue. Petitioner had no taxable income, for any year much less a taxable income for taxable year.

9. Untrue. Petitioner had no income since all he ever received was compensation.

10. For the years 1977, 1978, 1979 and 1980, petitioner was not required to file Federal tax returns due to lack of income.

11. Denied, pure assumption.

12. Petitioner has every reasonable cause not to file. Privacy Act and Paperwork Reduction Act. Oliver v. Halsteadt, 96 S.E. 2d 858, 859.

13. Denied. No underpayment of tax was made for any of these years. There is no negligence or intentional disregard of any mandatory rules or regulations. Voluntary regulations may be disregarded without punishment or these regulations would be mandatory.

14. Denied. No taxable years for petitioner have been established.

15. Denied. Petitioner never underpaid any estimated tax.

NEW MATTER

> Petitioner respectfully petitions this court to take judicial notice of U.S. v. Aitken 84-1614 and give petitioner a determination of the word income, or in the alternate tell petitioner which code section I can find the word defined at. The prosecution is moving forward under assumptions which have never been declared to be so. There rests a responsibility with the senior attorney of the Internal Revenue Service to know what income is. Bothke v. US 713 F2d 1405 (1983).
>
> Petitioner motions this court to dismiss this harassment due to lack of income for the years in question.
>
> Petitioner also respectfully requests to appear in the Court of proper jurisdiction, which should be the tax court of the United States since petitioner is a Citizen of one of the United States and not one that is included in the United States' tax code.

This case was placed on a calendar for trial in Pittsburgh, Pennsylvania, commencing May 27, 1986, and respondent's Motion for Summary Judgment was also placed on that calendar for disposition. Previously, petitioner had filed an "Objection to Respondent's Motion for Summary Judgment" stating that he had never previously received the Request (a copy of which was attached to respondent's Motion for Summary Judgment) upon which respondent's motion was based (although he subsequently admitted that the address to which the Request for Admissions was mailed was his correct address), and asserting various frivolous tax protester objections.

When the case was called from the calendar in connection with respondent's Motion for Summary Judgment, petitioner appeared in person and was heard. At the hearing the Court read

into the record or summarized therein each of petitioner's responses to the matters contained in respondent's Request. Petitioner continued to press his contention that compensation for labor is not income. He also continued to demand that he be cited to the Code section which defines the term "income." At this point the following colloquy occurred:

> THE COURT: Well, I'm sorry. I just don't think we're going to get anywhere with this hearing.
>
> Do you have any wish to try to prove any of your income or your deductions in this Court? Because if you don't, we might as well conclude this proceeding right now.
>
> MR. DeVILLARS: I have nothing now --
>
> THE COURT: Okay.
>
> MR. DeVILLARS: -- to prove that.

Although Rule 90(f) permits the withdrawal or modification of admitted matters when the presentation of the merits of the case will be subserved thereby and the party (here, respondent) who obtained the admission fails to satisfy the Court that the withdrawal or modification will prejudice him in prosecuting his case or in its defense on the merits, we think it is clear that the frivolous and peremptory nature of petitioner's tardy responses to the Request, his adamant pressing of tax protester arguments at the hearing and his declining the opportunity to offer substantive evidence as to his income and deductions at the trial make it evident that no basis exists for our directing the

withdrawal or modification of the deemed admissions. The matters deemed admitted by petitioner will therefore stand. Dahlstrom v. Commissioner, 85 T.C. 812, 818-819 (1985).

Respondent's Motion for Summary Judgment will be granted. Petitioner is deemed to have admitted the amounts of gross income from business, cost of goods sold, deductible business expenses for sales activities, interest income, alimony expenses, deductible itemized expenses, taxable income and income tax, income tax deficiencies and additions to tax under sections 6651(a)(1), 6653(a)(1) and 6654(a) as stated in the Request, which are the same as those determined in the deficiency notice. Petitioner has the burden of proof as to all of these items. Rule 142(a). Petitioner further has admitted that he could produce no evidence to challenge the Commissioner's determination.

Compensation for services is taxable income, not forbidden by the Constitution. Lonsdale v. Commissioner, T.C. Memo. 1981-122, affd. 661 F.2d 71 (5th Cir. 1981).

In addition, we patiently repeat a long-standing definition of income contained in an opinion by Judge Learned Hand: "[i]ts meaning [of income] is * * * to be gathered from the implicit assumptions of its use in common speech." United States v. Oregon-Washington R. & Nav. Co., 251 F. 211, 212 (2d Cir. 1918). We have adopted this definition as our own. Hellermann v. Commissioner, 77 T.C. 1361, 1366 (1981).

To reflect the foregoing,

An appropriate order will be entered.

Jul 11.7/2:1986-375

AUG 19 1986 COMPLETED 9 mf211

T. C. Memo. 1986-375

ORIGINAL

UNITED STATES TAX COURT

ANGUS CAMPBELL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 35725-83. Filed August 13, 1986.

Peter R. Stromer, for the petitioner.

Frank Laurino, for the respondent.

MEMORANDUM FINDINGS OF FACT
AND OPINION

KÖRNER, Judge: For the calendar year 1981, respondent determined a deficiency of income tax against petitioner in the amount of $6,188, together with additions to tax under section 6653(a)(1)[1/] of $309.40, and under section 6653(a)(2) in the amount of 50 percent of the interest due on $5,354. At the time of trial, respondent also requested the Court to award damages in

1/ All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

BEST COPY AVAILABLE

favor of the United States under section 6673. The issues which we must resolve are: (1) Whether petitioner is entitled to a deduction of $1,820 on account of alimony allegedly paid to his former wife; (2) whether petitioner is entitled to a personal exemption of $1,000 for the alleged support of a dependent child; (3) whether petitioner is entitled to a charitable contribution deduction on account of the alleged donation of $4,100 to the Life Science Church; (4) whether petitioner is entitled to a charitable contribution deduction for the alleged contribution of $10,000 to the Church of St. Thomas; (5) whether respondent correctly determined additions to tax against petitioner for negligence under the provisions of sections 6653(a)(1) and 6653(a)(2); and (6) whether an award of damages in favor of the United States under section 6673 is warranted.

FINDINGS OF FACT

Some of the facts herein were stipulated and such stipulation together with attached exhibits is incorporated herein by this reference.

At the time of filing his petition herein, petitioner was a resident of Jamaica, New York. His individual income tax return for the calendar year 1981 was timely filed with respondent.

In the year 1981, petitioner paid the amount of $4,100 to the Life Science Church. He did not become a member of that church, nor was he ordained as a minister in that church, nor did he receive a charter for the establishment of a local chapter of that church. He did, however, receive various written materials

BEST COPY AVAILABLE

from the church giving him information as to how to become a minister and how to establish a church. Petitioner used these materials, together with information obtained from other sources, to prepare organizing documents for "the Church of St. Thomas," an unincorporated association, which was established by himself and one Joanne Kelly at a meeting between the two of them on November 9, 1981. The record herein does not disclose that the Church of St. Thomas had any congregation, had any religious or other charitable program, conducted any religious services, or engaged in any other activity. The location of the church was stated to be at 166-05 Highland Avenue, Jamaica, New York, which was also petitioner's residence. Petitioner neither sought nor obtained a ruling from the Internal Revenue Service that the Church of Saint Thomas was an exempt organization under section 501(c)(3), to which deductible contributions under section 170 could be made.

In his tax return for the year 1981, petitioner claimed a charitable deduction in the amount of $4,100, for the money which he had paid to the Life Science Church. Petitioner also claimed a charitable deduction, in the amount of $10,000, for an alleged donation to the Church of St. Thomas.

In arriving at his adjusted gross income on the income tax return filed, petitioner deducted the amount of $1,820 on account of alimony allegedly paid to his former wife. Petitioner further claimed a personal exemption, in the amount of $1,000, for a minor child, Robyn Campbell.

BEST COPY AVAILABLE

Upon audit, respondent disallowed both the above claimed charitable deductions, and also disallowed the claimed deductions on account of alimony and the personal exemption for Robyn Campbell. Respondent further determined an addition to tax under section 6653(a)(1), in the amount of 5 percent of the entire deficiency, and a further addition to tax under section 6653(a)(2) of 50 percent of the interest on $5,354.00, which amount constituted the deficiency attributable to the disallowance of the two claimed charitable deductions.

OPINION

As to all the issues which are to be resolved herein, with the exception of issue no. 6, the burden of proof in this case was upon petitioner, to prove by preponderance of the evidence his right to the claimed deductions and exemption. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). As to the first five issues, we sustain respondent because of petitioner's almost total failure to carry such necessary burden of proof.

1. Exclusion of Claimed Alimony Payment.

2. Personal Exemption Deduction for Minor Child.

Petitioner's evidence with regard to the claimed deduction of alimony payments was his unsubstantiated testimony that he had been divorced from Catherine Campbell during the year 1971, that the divorce decree provided for alimony payments from him to his former wife in the amount of $35 a week, and that he had faithfully paid such amounts to his former wife in the year 1981,

BEST COPY AVAILABLE

totaling $1,820. Petitioner's former wife was not called as a witness to corroborate his testimony as to these payments, and no other evidence, in the form of canceled checks or otherwise was presented.2/ We are not required to accept petitioner's self-serving and uncorroborated testimony, particularly where other and better evidence to prove the point in question was available. See Wood v. Commissioner, 338 F.2d 602, 605 (9th Cir. 1964), affg. 41 T.C. 593 (1964).

With respect to the alleged payments for child support, once again this record contains nothing but petitioner's unsupported testimony that such payments of $20 a week were made, to support his claim of a personal exemption under the provisions of sections 151 and 152.3/ No canceled checks or other evidence of payment was offered; there was no evidence whether petitioner was the custodial or noncustodial parent of the minor child, see sec.

2/ At trial, petitioner offered in evidence a purported copy of a divorce decree from the State of New York, for the purpose of corroborating his testimony as to (a) the fact of the divorce; (b) the obligation of petitioner to make alimony payments of $35 a week; and (c) petitioner's obligation to make payments of $20 a week for the support of his minor child Robyn. Admission of this exhibit was refused by the Court on the grounds that petitioner had failed to comply with the clear provisions of the Court's Pretrial Order in this case, that the parties, not less than 20 days prior to trial should, inter alia, exhibit to each other any documentary evidence intended to be offered at trial. The purpose of the Court's Pretrial Order was to avoid surprise, promote stipulation of uncontroverted facts and exhibits, and shorten trial time. Even if admitted, such exhibit would have done nothing more than establish petitioner's obligation to make the payments, without proving in any way that such payments had in fact been made.

3/ See footnote 2, supra.

BEST COPY AVAILABLE

152(e), nor was there any proof that petitioner provided more than half of the child's support during the year 1981, see sec. 152(e)(2).

As to both these issues, respondent is accordingly sustained.

3. Claimed Charitable Contribution to Life Science Church.

4. Claimed Charitable Contribution to the Church of St. Thomas.

Petitioner satisfactorily proved that he paid $4,100 to the Life Science Church in 1981. However, he failed to prove either (a) that the Life Science Church was an exempt organization to which deductible contributions under section 170 could be made, and (b) he failed to prove that his payment of $4,100 was a free-will donation. Indeed, this record contains strong indications that, in return for his $4,100, petitioner received instructions and printed materials from the Life Science Church regarding the proper way to set up a church, become a minister, and the like, some of which he later used in organizing the Church of St. Thomas. Whether the amounts which petitioner paid for this instruction and these materials was too much or too little is not for us to judge. To the extent that it was for such instruction and educational materials, however, there was a quid pro quo involved, and it was clearly not a free and disinterested charitable contribution.

BEST COPY AVAILABLE

With respect to the alleged donation of $10,000 to the Church of St. Thomas, petitioner's proof is even more deficient. It was not established in this record that the contribution of $10,000 in 1981 was made at all.[4/] Petitioner having failed to prove that he made a contribution of any amount to the Church of St. Thomas in 1981, we need not examine the further questions presented herein, viz, whether the Church of St. Thomas was an exempt organization to which deductible contributions under section 170 could properly be made, whether any of such funds in the custody of the Church of St. Thomas inured to petitioner's benefit, or whether in fact petitioner made a completed gift by parting with all dominion and control over the alleged $10,000. See Davis v. Commissioner, 81 T.C. 806 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985).

As to both the above issues, we accordingly sustain respondent.

4/ At trial, petitioner again attempted to introduce certain documentary evidence in the form of a bank statement for an account maintained in the name of the Church of St. Thomas, copies of certain checks drawn on said account, and copies of deposit slips allegedly showing deposits to such account. Such exhibits were refused admission because (a) in the case of the bank statement, the proposed exhibit had not previously been exhibited to respondent's counsel in accordance with the terms of the Court's Pretrial Order in this case, and (b) in the case of the copies of checks and deposit slips, the originals of said documents were not made available so that the copies could be verified as to accuracy. Even if such documents had been admitted in evidence, they would have proved only that a deposit of $10,000 was made in 1981 to a bank account maintained in the name of the Church of St. Thomas, without proving that such amount came from petitioner.

BEST COPY AVAILABLE

5. Additions to Tax Under Section 6653(a).

Respondent determined an addition to tax under section 6653(a)(1) for the entire deficiency here in issue, on account of petitioner's negligence or intentional disregard of rules and regulations, and respondent further determined an addition to tax under section 6653(a)(2), limited to 50 percent of the amount of deficiency attributable to the disallowance of the two claimed charitable contributions discussed above.

The burden of proof as to these additions to tax was on petitioner, Enoch v. Commissioner, 57 T.C. 781, 803 (1972); Bixby v. Commissioner, 58 T.C. 757, 791 (1972). The record herein discloses that petitioner made no serious effort to determine whether the "Church of St. Thomas," which he and another person organized in 1981, met either the organizational or operational tests provided by the Code and respondent's regulations thereunder. See secs. 170, 501(c)(3). He got some materials from the Life Science Church, and he talked to various individuals, none of whom were shown to have had any expertise in these matters, about the adequacy of what he was doing. He did not consult an attorney or anyone else skilled in tax matters. The record does not disclose that the Church of St. Thomas ever undertook any active charitable or religious program, had any congregation, or did anything else. Given these failures of proof, we sustain respondent's determinations of additions to tax.

BEST COPY AVAILABLE

6. Award of Damages Under Section 6673.

Prior to the trial herein, respondent notified petitioner that if he persisted in pressing the case, respondent would seek an award of damages in favor of the United States under the provisions of section 6673. That section provides, in relevant part:

> Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. * * *

We have considered this matter carefully and have determined that damages under section 6673 should not be awarded in this case. While petitioner has clearly failed on all issues presented, it was at least possible that petitioner might have prevailed on his claims with respect to alimony payments and the personal exemption for a minor child, if petitioner and his counsel had properly prepared the case for trial in compliance with the Court's Pretrial Order. Their wanton disregard of that Pretrial Order has cost them dearly, but we are not prepared to say that the action was instituted for delay or that the petitioner's position on all issues herein was frivolous or groundless. Accordingly, no damages herein will be awarded.

Decision will be entered for respondent.

BEST COPY AVAILABLE

COMPLETED Ju 11.7/2:1986-376
13

ORIGINAL

T. C. Memo. 1986-376

UNITED STATES TAX COURT

DAVID A. WEINSTEIN AND EILEEN WEINSTEIN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25898-81. Filed August 13, 1986.

Wilbur Greenberg, for the petitioners.

Kenneth J. Rubin, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined a deficiency of $25,403.56 in petitioners' income tax for 1976. The only issue is whether petitioners are entitled to deduct a loss in the amount of $55,639 as a result of the interest of petitioner David A. Weinstein in a partnership known as Cay Associates.

BEST COPY AVAILABLE

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and exhibits attached thereto are incorporated herein by reference.

Petitioners, David A. and Eileen Weinstein, husband and wife, resided in Philadelphia, Pennsylvania, at the time they filed their petition. They filed a joint income tax return for 1976 with the Internal Revenue Service Center in Philadelphia.

In early 1976, David A. Weinstein (hereinafter referred to as petitioner) became interested in coal tax shelters. Prior to that time he had no experience in the coal business. In June 1976 he met and discussed coal tax shelters with David Wasserstrom, who had been introduced to petitioner as an excellent tax attorney. Subsequently they contacted a Pennsylvania coal company about leasing some coal properties, but no lease was obtained at that time.

Later in the summer of 1976, Wasserstrom called petitioner to determine if he was still interested in a coal shelter. Petitioner met with Wasserstrom and was told about a large tract of land in West Virginia which, according to Wasserstrom, was to be divided into six sites for lease to six separate partnerships.

On October 1, 1976, petitioner received from Wasserstrom an engineering report concerning the proposed coal sites and a preliminary draft of an offering memorandum. Wasserstrom told

BEST COPY AVAILABLE

petitioner that the land would be leased by the partnerships from Cannon Coal Company ("Cannon Coal"), whose principals according to Wasserstrom were Frederick Gagnon and Bernard Boyers.

Subsequently, petitioner agreed to be the general partner of Cay Associates, a limited partnership formed on December 21, 1976, for the stated purpose of mining coal on Parcel No. 3 (Parcel 3) of a tract of land in West Virginia known as the J. L. Beury Estate (Beury Tract).

As general partner, petitioner made a cash contribution of $1,000 to Cay Associates and received a 2.5 percent interest in the partnership. There were 25 limited partners each of whom contributed $25,000 and received a 3.9 percent interest. The total initial capitalization of Cay Associates was therefore $626,000.

The interests in Cay Associates were sold pursuant to a private offering memorandum prepared by Wasserstrom. The memorandum contained a revised version of the engineering report petitioner had been shown in October. The original report had been prepared by Brackenrich & Associates, Inc. for Cannon Coal, and estimated that approximately 950,000 tons of coal was recoverable from Parcel 3. At some point after the original report was sent by Brackenrich to Cannon Coal, it was altered in such a way as to increase both the acreage and the estimated coal reserves in Parcel 3. In the altered report it was estimated that

BEST COPY AVAILABLE

1,250,000 tons of coal were recoverable. The original report reflecting only 950,000 tons was not used in the promotion of Cay Associates.

The altered report (hereinafter Brackenrich Report) was accompanied by a covering letter from J. D. Brackenrich dated October 13, 1976, which stated, in part:

> This report is intended to show an estimate of recoverable reserves of coal on the tract. No core-drillings were made and no surface prospecting was done. * * *
>
> Confirmation of the reserve study should be accomplished by additional surface prospecting and core-drilling. * * *

Using the figures in the Brackenrich Report, the offering memorandum projected that a $25,000 investment in the partnership would yield a net profit. Relying exclusively on the Brackenrich Report petitioner concluded that the Beury Tract was an economically promising coal property. However, he had no personal knowledge of Brackenrich's reputation, qualifications, or experience and he did not discuss with anyone the advisability of making further tests to confirm the report's estimates as recommended in the covering letter. Prior to trial petitioner had visited Parcel 3 on two different occasions, once in April of 1977 and again in August of the same year.

On December 23, 1976, Cay Associates entered into a sublease agreement with Cannon Coal, under which Cay Associates was given the right to mine and remove all coal on Parcel 3. At or about

BEST COPY AVAILABLE

the same time the other five parcels in the Beury Tract were each subleased under similar terms and conditions by Cannon Coal to a separate limited partnership.

Under the sublease Cay Associates was required to pay Cannon Coal a minimum royalty of $5.00 per ton of coal mined from Parcel 3 less a credit of $2.25 per ton on an advance royalty of $2,225,000, payable as follows: $475,000 in cash upon the execution of the lease, and a nonrecourse note for $1,750,000 payable in equal quarterly installments to December 31, 1983. In accordance with the sublease, petitioner, as general partner of Cay Associates executed the nonrecourse promissory note to Cannon Coal in the amount of $1,750,000 (the "royalty note").

The entire sublease including the amount of the advance royalty was negotiated for Cay Associates by Wasserstrom. Petitioner did not participate in the negotiations. At that time, Wasserstrom was the president of Seah Corporation, which was the sole shareholder of Cannon Coal.

In addition to the sublease, Cay Associates entered into a contract with Black Rock Mining Company ("Black Rock"), under which Black Rock agreed to mine and remove the coal from Parcel 3 in return for a percentage of the gross receipts from the sale of the coal. Under the contract Black Rock was not responsible for any start-up costs of the mining operation. Black Rock's principal officers and only shareholders were Gagnon and Boyers, who also controlled Fre Bern Energy, a West Virginia partnership

BEST COPY AVAILABLE

that contracted with Cay Associates to serve as sales agent and marketing consultant with respect to any coal mined by Cay Associates.

In the first week after its formation on December 21, 1976, Cay Associates disbursed $623,750 of its initial capital of $626,000. The disbursements included $475,000 to Cannon Coal on the advance royalty and $20,000 to petitioner for services as general partner. No mining operations occurred in 1976.

As of August 1977, no mining operations had begun on any of the Beury parcels. Some mining was done later on two of the parcels, but these mines were quickly abandoned when their roofs collapsed. No mining was ever done on Parcel 3.

After the mining on two of the parcels was abandoned, Cannon Coal gave the six limited partnerships a joint lease on property located in Kentucky. Although some mining took place on the Kentucky property, it did not extend beyond three months.

On its partnership return for 1976, Cay Associates claimed a loss of $2,225,563, by deducting the entire advance royalty plus $563 in organizational expenses. Petitioner's share of the loss, $55,639.00, was used on petitioners' 1976 return to offset taxable income from other sources. Respondent disallowed the loss in its entirety.

BEST COPY AVAILABLE

OPINION

The loss claimed by petitioner consists of his share of the advance royalty and his share of the organizational expenses reported on the partnership return of Cay Associates. Since petitioner has presented no evidence in support of his deduction for organizational expenditures, respondent's determination with respect thereto is sustained. Rule 142(a).[1]

With respect to the advance royalty, respondent claims that no deduction is allowable because the partnership was not engaged in a trade or business under section 162.[2] For the reasons stated below, we agree with respondent.

To constitute the carrying on of a trade or business under section 162, an activity must "be entered into, in good faith, with the dominant hope and intent of realizing profit, i.e., taxable income, therefrom." Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court. See also Hager v. Commissioner, 76 T.C. 759, 784 (1981), and the cases cited therein. The expectation of a profit need not be a reasonable one. It is sufficient if there is a bona fide objective of making a profit. Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230

---

[1] All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided. All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, unless otherwise indicated.

[2] Petitioner relies solely upon section 162 and does not claim that the royalty is deductible under sections 212 or 183.

BEST COPY AVAILABLE

(4th Cir. 1984), affd. without published opinions sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984); Hager v. Commissioner, supra. Whether there is an objective to make a profit is a factual determination to be resolved from all the surrounding circumstances. Golanty v. Commissioner, 72 T.C. 411, 426 (1979), affd. in an unpublished opinion 647 F.2d 170 (9th Cir. 1981); Dunn v. Commissioner, 70 T.C. 715, 720 (1978), affd. 615 F.2d 578 (2d Cir. 1980).

The burden of proof with respect to the requisite objective is on petitioners. Rule 142(a); Golanty v. Commissioner, supra at 426. In making this determination, [as to intent] objective facts are to be given greater weight than the parties' statements of their intent. Fox v. Commissioner, supra at 1007.

Whether a partnership is engaged in a trade or business with the objective of making a profit is to be determined at the partnership level. Fox v. Commissioner, 80 T.C. at 1006; Siegel v. Commissioner, 78 T.C. 659, 698 (1982); Brannen v. Commissioner, 78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984). In determining the profit objective of a limited partnership where the conduct of the partnership's affairs was left to the general partner, attention must be focused upon the general partner's knowledge, conduct, expertise and success in the particular field as well as any other factor which he relied

BEST COPY AVAILABLE

upon in making partnership decisions. See Siegel v. Commissioner, supra; Brannen v. Commissioner, supra; Hager v. Commissioner, supra.

In Golanty v. Commissioner, supra, we set forth a list of factors that have been considered relevant in previous cases to a determination of whether an activity was entered into for profit. We find that the following factors from that list are relevant here: (1) The manner in which the activity was conducted; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets would appreciate in value; (5) the taxpayer's history of income or losses with respect to the activity; and (6) the amount of profits, if any, which were earned.

Before considering the above factors, we note that, in a district court proceeding brought against petitioner and others by two limited partners in Cay Associates, petitioner testified that Cay Associates was formed for the primary purpose of obtaining tax benefits. That statement of petitioner's intent is well supported by the nonbusinesslike manner in which the partnership venture was conducted. From the outset, it was destined to create nothing but losses because the advance royalty agreed to by petitioner as general partner was so large that it was extremely unlikely that the partnership could even pay off the royalty note. Donald Bondurant, an expert witness for respondent, is a mining engineer familiar with West Virginia properties. He examined Parcel 3 and

BEST COPY AVAILABLE

the other parcels on the Beury Tract and prepared a report in which he concluded that the potential recoverable coal reserves on Parcel 3 totaled only 146,247 tons, as compared to the 1,250,000 tons estimated in the altered Brackenrich Report. If his conclusion is correct, and if we assume that the partnership was able to recover all 146,247 tons, the partnership's income, after expenses, would have been approximately $450,000 less than the $1,750,000 royalty note.[3]

Bondurant's estimate obviously conflicts with Brackenrich's estimate. However, we are satisfied that the Bondurant estimate is more reliable for several reasons. First, the Brackenrich Report in tne offering memorandum had been altered to inflate both the size of Parcel 3 and the estimate of recoverable coal. Second, the recovery factor[4] used in the Brackenrich report was unrealistically high. Third, the Brackenrich Report ignored

---

[3] The partnership's potential income, after expenses, was computed as follows:

Tons of Coal	$ 146,247.00
Times the Sales Price per Ton	$ 36.00
	5,264,892.00
Less Black Rock's Minimum Commission of 66% of Gross Sales	3,474,828.70
	1,790,063.30
Less Management Fees of $.60 per ton	87,748.20
	1,702,315.10
Less Cannon Coal's Royalty of $2.75 per ton	402,179.25
Income, After Expenses	$1,300,135.90

[4] The "recovery factor" is the percentage of coal on the site that can be commercially mined.

BEST COPY AVAILABLE

readily available geological and mining data regarding the Beury Tract. This data included six previous core-drillings on the Beury Tract and a prior unsuccessful mine on Parcel 3.

Petitioner claims that even if the Brackenrich Report was erroneous, he was entitled to rely on it. Although there may be circumstances under which a taxpayer may rely on an erroneous estimate or appraisal to justify an investment, those circumstances are not present here. The first page of the report warned tne reader that the findings set forth therein were based on visual inspections of other parcels and that core-drillings should be made to confirm the findings. Petitioner, however, did not discuss the advisability of making core-drillings with anyone and made no effort to determine Brackenrich's reputation and qualifications. In other words, petitioner accepted the report at face value, without taking any of the usual precautionary measures expected of a reasonable and prudent investor.

In addition to agreeing to pay an unjustifiably high royalty, other nonbusinesslike activity on petitioner's part included failing to inspect the property until more than four months after the lease was signed and only twice during the entire operation. Furthermore, his spending of all but $2,250 of the partnership's capital within the first week of its existence and thereby leaving it with insufficient funds to commence mining operations, cannot be considered the act of a prudent businessman. Petitioner claims

BEST COPY AVAILABLE

that he was told by Wasserstrom that Cannon Coal agreed to advance such funds, but there is no such provision in the contracts, nor any other evidence, of such an agreement.

Petitioner also did not act as a prudent businessman in permitting Wasserstrom to represent the partnership in negotiations with a corporation in which Wasserstrom had a substantial interest. Even if petitioner was not aware of this conflict of interest, his lack of such knowledge was due to his negligence in not ascertaining the relationship.

Turning to the other factors listed in Golanty, we have found that petitioner had no previous experience in the coal business and has presented no evidence that any of his advisers had such experience. Although petitioner contends that he spent considerable time and effort in carrying on the venture, we are unable to make such a finding since the only evidence presented on this point consisted of self-serving memorandums by petitioner to his files.

With respect to history of the partnership's profits and losses, we find there is no history of profits because the partnership never even had any receipts from the venture and therefore incurred nothing but losses.

From all of the foregoing, we conclude that the partnership venture was not an activity engaged in for profit and, thus, did

BEST COPY AVAILABLE

not constitute the carrying on of a trade or business.[5] Consequently, petitioner is not entitled to deduct his share of any part of the partnership loss.

Decision will be entered for respondent.

[5] Because we find that the partnership venture did not constitute the carrying on of a trade or business, it is unnecessary to address respondent's alternative arguments that section 1.612-3(b)(3), Income Tax Regs., prohibits deducting the advance royalty and that any permissible deduction should not include the amount of a non-recourse royalty note.

BEST COPY AVAILABLE

AUG 19 1986

COMPLETED
25

Ju 11.7/2:1986-377

MF211

CONT

T. C. Memo. 1986-377

ORIGINAL

UNITED STATES TAX COURT

SHASTA INDUSTRIES, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 28705-84. Filed August 14, 1986.

John F. Daniels, III, for the petitioner.

Martha J. Combellick, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GOFFE, Judge: The Commissioner determined a deficiency in petitioner's Federal income tax for the taxable year ending January 31, 1981,[1] in the amount of $134,649. After concessions by respondent, the issue for decision is whether the use of the LIFO method for valuing work-in-process inventory by petitioner is compatible with the use of the completed contract method.

---

1 For convenience and clarity, each taxable year ending on January 31 will be referred to solely by the year in which petitioner's fiscal year ended.

BEST COPY AVAILABLE

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated by reference.

At the time the petition was filed, Shasta Industries, Inc. (hereinafter referred to as Shasta or petitioner) was an Arizona corporation with its principal place of business in Phoenix, Arizona. Shasta was incorporated in Arizona in 1962. Its principal business, conducted under the name "Master Pools," involved the construction of commercial and residential in-ground swimming pools. Approximately 75 percent of the petitioner's total sales resulted from the construction of residential swimming pools during the taxable year at issue. Petitioner constructed approximately 1,500 to 2,000 swimming pools per year, approximately 10 percent of which were not completed at the end of any one taxable year. The average time for completion of a contract to build a residential swimming pool was 30-35 days. The average time for completion of a contract to build a commercial swimming pool was 2 months. An average pool weighs approximately 40 tons. Shasta was also engaged in the wholesale and retail sales of pool equipment, supplies, chemicals, landscaping, and spas.

BEST COPY AVAILABLE

A standardized set of two documents was used to formalize the contractual relationship between Shasta and its customers. Petitioner used a Sales Contract as the preliminary contract. The portion of paragraph 7 of the Sales Contract that deals with risk of loss and ownership provides:

> Any pool equipment or appurtenances subject to this contract delivered to the job site are the Owner's property and if removed or stolen are Owner's responsibility.
>
> * * *
>
> Owner agrees that during construction of the swimming pool, he will be liable for any damage to any part of the swimming pool by irrigation water, vandals, or any other persons or things not within the control of the Contractor.

The initial Sales Contract established terms of payment as follows: 40 percent on the day of excavation, 30 percent on the day that the steel and plumbing were installed, 25 percent on the day that the gunite (a form of concrete) was applied, and the remaining 5 percent before plastering.

After the customer and petitioner executed the Sales Contract, an employee of petitioner was sent to the site where the pool was to be constructed to lay out the size and shape of the pool on the site. After the layout was completed and acceptable to the customer, the customer or an authorized representative executed the Pool Layout Acceptance Form which, together with the Sales Contract and any addenda, constituted the

BEST COPY AVAILABLE

legal agreement between the customer and Shasta. The Pool Layout Acceptance Form, exclusive of filled-in items that were peculiar to each job, read as follows:

> After careful examination of our site with the layout foreman, I/we accept the layout, elevation, location, contour, size. and shape of the pool to be constructed in our yard.
>
> I agree that the signing of this accepts, without recourse, all of the above listed conditions.
>
> It is further expressly agreed by and between Master Pools and buyer herein that all right, title, possession and interest in the pool, plumbing equipment, fixtures and accessories shall remain in Master Pools until the entire purchase price of said pool has been paid and purchaser herein expressly grants permission to Master Pools to retake possession of said items for failure to complete full payment of the purchase price and does waive any claim for damages arising from said repossession. I acknowledge receipt of copied documents which include contract, plan, N.S.P.I. disclosure Arizona Chapter, and all addendums (if any).

Construction did not begin until after the execution of this form.

Upon completion of the pool, the customer was presented with a form called a Completion Certificate which was to be signed and returned to petitioner. These three documents, the Sales Contract, the Pool Layout Acceptance Form, and the Completion Certificate, were the primary documents signed by the customer unless the job entailed unusual costs of construction that required the execution of addenda authorizing additional costs.

The construction process used by Shasta was as follows: First, a layout man measured the pool location and staked out where the pool was to be constructed and determined if any

BEST COPY AVAILABLE

utility rerouting was required. The customer executed the Pool Layout Acceptance Form at this time. The physical construction then began. At each stage of the pool construction, a construction coordinator selected the crews to perform the particular function and scheduled their projects. The layout site was excavated including dynamiting or other special techniques if necessary. The plumber installed the filter, pump, motor, and the skimmer. Steel reinforcing bars were used to form a metal basket to fit the excavation and form the shape of the pool. Wiring was then added to the pool site. The necessary electrical work was done before the concrete was poured, covering the steel, plumbing and electrical work. Tile was placed around the pool surface and the deck around the pool was constructed. Final details of construction were the cleanup of the pool area, setting of the turbos, and plastering of the pool. Equipment needed to service the pool was then delivered to the pool site and the operation of the pool was explained to the customer.

Most of the material and equipment used to construct the swimming pools was kept in the warehouse as inventory. The raw materials used were primarily concrete, plaster, and gunite. Construction materials obtained from inventory included a portion of the raw materials. Other items kept in inventory were: (1) plumbing materials; (2) steel; (3) heaters; (4) diving boards and slides; and (5) pool equipment such as pumps, filters, skimmers, and turbos. Some tile was also maintained as inventory.

BEST COPY AVAILABLE

Although most supplies came from the warehouse, some materials such as concrete and tile were purchased for specific contracts and normally delivered directly to the pool site. The crew for a specific phase usually went to the warehouse to pick up equipment or materials as required for the particular swimming pool. The materials or equipment that had been removed from the warehouse and used for a particular pool were removed from the inventory of construction materials and included in the work-in-process inventory for swimming pools. Specific materials required for a particular swimming pool that were not in the warehouse were allocated to the particular job as the invoices were submitted. Each of the costs for materials associated with the various phases of construction were posted at the first-in/first-out (FIFO) costs at which the items were warehoused or at the cost of purchase for newly acquired items. The costs for all completed pools and all work-in-process were converted to last-in/first-out (LIFO) at the end of the taxable year by use of a LIFO reserve account. Appropriate amounts were transferred from the work-in-process and LIFO reserve accounts to cost of goods sold for pools completed during the taxable year. The costs of pools that were not completed in a particular taxable year remained in the work-in-process and LIFO reserve accounts for adjustment at the end of the subsequent taxable year.

BEST COPY AVAILABLE

From its inception through the taxable year 1978, Shasta used the FIFO method of inventory identification. As provided by section 472,[2] Shasta applied, beginning with the taxable year 1979, to adopt and use the LIFO inventory method for raw materials inventory and work-in-process inventory for swimming pools under construction. It filed its election to adopt the LIFO method with its return for the taxable year 1979. In its LIFO election, petitioner elected to determine inventory costs by using the average cost of goods purchased during the year and also elected the dollar value, double-extension method of valuing LIFO inventories. This method of determining the costs of inventory required conversion at the end of the taxable year of the FIFO costs of items removed from the warehouse to the LIFO costs used to determine the costs of sales upon completion of each contract. The LIFO election was not made with respect to the inventories of pool equipment, supplies, and chemicals held by petitioner for sale on a retail or wholesale basis. The FIFO method of inventory continued to be used for these items.

Shasta maintained work-in-process accounts for swimming pools, which included the costs of licenses and fees, raw materials and equipment taken from inventory or acquired during construction, and direct labor and overhead. Beginning with the taxable year 1979, Shasta used the LIFO cost method of inventory

---

2 All section references are to the Internal Revenue Code of 1954, and attendant regulations as amended and in effect for the relevant years, and all Rule references are to this Court's Rules of Practice and Procedure.

BEST COPY AVAILABLE

pricing with respect to both raw materials and work-in-process. Shasta maintained LIFO reserve accounts to reflect the difference between its FIFO and LIFO costs. The LIFO reserves were calculated using the dollar value, double-extension LIFO method which determines costs at the end of the taxable year rather than on an item-by-item basis. The LIFO reserves for work-in-process were not deducted as cost of goods sold until completion of a contract.

The accumulated LIFO reserve accounts that reflected the difference between the FIFO costs used in the warehouse inventory and on the job sheets, and the LIFO costs used for income tax reporting purposes were in the following accumulated amounts at the end of each taxable year as follows:

	1979	1980	1981
Work-in-Process	$140,588	$312,452	$271,584
Raw Materials	23,980	45,578	36,537
LIFO Reserve	$164,568	$358,030	$308,121

Petitioner filed its income tax returns on the basis of a fiscal year ending on January 31. For Federal income tax reporting purposes, Shasta generally used the accrual method of accounting. However, Shasta used the completed contract method of accounting to report profits and losses from its Master Pools operations. Since its inception, petitioner has consistently used a completed contract method of accounting for its income and expenses with respect to the construction of swimming pools for Federal income tax purposes. For financial accounting purposes, Shasta used the percentage of completion method through the

BEST COPY AVAILABLE

taxable year 1978. Beginning with the taxable year 1979, Shasta used the completed contract method for both tax and financial accounting purposes. Under this method, petitioner recognized income at the completion of a contract, at which time the associated costs were removed from the work-in-process inventory accounts valued at LIFO and charged to costs of goods sold. Shasta did not recognize any advance payments under a purchase order or a long-term contract until the completion of each contract.

The gross sales, cost of goods sold, gross profit, and gross profit percentage for the taxable years 1979, 1980, and 1981 have been computed for the Master Pools division of Shasta, under the completed contract method, first using the LIFO inventory method actually used by Shasta and second using the LIFO inventory method for warehouse inventory, FIFO inventory method for work-in-process:

TAXABLE YEAR 1979

	Actual	Using FIFO Work-in-Process
Gross Sales	$11,081,028	$11,081,028
Cost of Goods Sold	8,713,980	8,737,960
Gross Profit	$ 2,367,048	$ 2,343,068
Gross Profit Percentage	21.36%	21.14%

TAXABLE YEAR 1980

	Actual	Using FIFO Work-in-Process
Gross Sales	$15,222,601	$15,222,601
Cost of Goods Sold	11,460,775	11,482,373
Gross Profit	$ 3,761,826	$ 3,740,228
Gross Profit Percentage	24.71%	24.57%

BEST COPY AVAILABLE

TAXABLE YEAR 1981

	Actual	Using FIFO Work-in-Process
Gross Sales	$12,541,429	$12,541,429
Cost of Goods Sold	9,604,068	9,595,027
Gross Profit	$ 2,937,361	$ 2,946,402
Gross Profit Percentage	23.42%	23.49%

The Commissioner issued a statutory notice of deficiency to petitioner for the taxable year 1981. The Commissioner determined that petitioner was not entitled to use the LIFO method to assign costs for materials purchased for long-term contracts or to use the LIFO method for labor and other costs applied in the completion of long-term contracts. The Commissioner stated that such costs were not inventory but were deferred expenditures which were to be treated as part of the cost of a particular long-term contract and were to be allowed as a deduction only for the year during which the contract was completed and the contract price reported as gross income. It was also determined that petitioner did not own all of the items included in inventory. Petitioner's cost of sales was accordingly decreased by the amount of the accumulated LIFO reserve as of the end of the taxable year 1981 in the amount of $308,121. The net result of this adjustment in petitioner's Federal income tax, and other adjustments that are not in issue, was a deficiency for the taxable year 1981 in the amount of $134,649. Respondent has conceded that petitioner's use of the LIFO method for valuing the four inventory categories of construction materials maintained in the warehouse was

BEST COPY AVAILABLE

permissible thereby, decreasing the adjustment proposed for the LIFO reserve in the taxable year 1981 from $308,121 to $271,584. Respondent's adjustment includes the entire amount of the LIFO reserve with respect to work-in-process that was accumulated over the course of three taxable years: 1979, 1980, and 1981, only the last of which is at issue. Should respondent prevail, petitioner has claimed a refund based on the decrease of the LIFO reserve from $358,030 at the end of the taxable year 1980 to $308,121 at the end of the taxable year 1981.

OPINION

The Commissioner's determination of deficiency, after concessions by respondent, increases petitioner's income by the entire amount of the accumulated LIFO reserve for work-in-process as of the end of the taxable year 1981, an amount that includes a carryover of reserves from two prior taxable years, 1979 and 1980. The adjustment was based upon a reallocation under section 481 due to the Commissioner's change in the method of accounting that he feels should have been used by petitioner.[3]

---

[3] Respondent proposes to prohibit the use of inventories with the completed contract method of reporting income which changes the taxpayer's method of accounting. Sec. 1.446-1(e)(2)(ii)(a), Income Tax Regs. If the Commissioner's change in accounting method results in the exclusion or duplication of taxable items, the Commissioner may adjust the taxpayer's income appropriately. Sec. 481; Primo Pants Co. v. Commissioner, 78 T.C. 705, 726 (1982). As the change in method of accounting proposed by respondent with respect to the taxable year 1981 is not taxpayer initiated, and would result in an increase in taxable income in excess of $3,000, the adjustments and limitations of secs. 481(a)(2) and 481(b) apply to limit the amount of deficiency that may be determined for the taxable year at issue with respect to adjustments resulting from the change in method of accounting.

BEST COPY AVAILABLE

The sole issue for decision is whether the use of LIFO inventories for work-in-process by petitioner is compatible with the use of the completed contract method for reporting income. Petitioner relies upon two recent cases of this Court holding that the use of inventories and the use of the completed contract method are not mutually exclusive and that they may be proper under the appropriate facts and circumstances, RECO Industries, Inc. v. Commissioner, 83 T.C. 912 (1984), on appeal (4th Cir., July 30, 1985); Peninsula Steel Products & Equipment Co. v. Commissioner, 78 T.C. 1029 (1982). Respondent contends, as was argued in RECO Industries, Inc. and Peninsula Steel Products & Equipment Co., that the taxpayer may not use the LIFO inventory method to identify costs with respect to work-in-process for which the income will be reported by the completed contract method, citing Spang Industries, Inc. v. United States, 6 Cl. Ct. 38 (1984), revd. 791 F.2d 906 (Fed. Cir. 1986). The reversal of the Claims Court by the Federal Circuit occurred after all briefs had been filed in this case.

The determinations of the Commissioner in his statutory notice of deficiency are presumptively correct and petitioner has the burden of disproving each individual adjustment. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Further, Congress grants the Commissioner broad discretion to determine whether or not a taxpayer's methods of accounting clearly reflect income. Secs. 446(b), 471; Commissioner v. Hansen, 360 U.S. 446, 467 (1959). Petitioner, therefore, bears the burden of proving that

BEST COPY AVAILABLE

the LIFO method of inventory is consistent with the reporting of its income under the completed contract method and that the concurrent use of both methods clearly reflects income.

The question of whether a particular accounting method clearly reflects income is primarily a factual question that varies from business to business. Sam W. Emerson Co. v. Commissioner, 37 T.C. 1063, 1067 (1962). Where the taxpayer demonstrates that his chosen method accords with generally accepted accounting principles, complies with respondent's regulations, and has been consistently used, the taxpayer's choice ordinarily will be regarded as clearly reflecting income. Secs. 1.446-1(a)(2), 1.471-2(b), Income Tax Regs.; RECO Industries v. Commissioner, supra at 920; Peninsula Steel Products & Equipment Co. v. Commissioner, supra at 1045.

Section 446(a) sets forth the general rule that taxable income is to be "computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Further, the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Sec. 451(a). Taxable income may be computed under any one of several methods of accounting: cash receipts and disbursements, accrual, any other method permitted by Subchapter E (sections 441 through 483), or any combination of the foregoing methods permitted under

BEST COPY AVAILABLE

the regulations. Sec. 446(c). The method of accounting includes not only the overall method of accounting but also the accounting treatment of any material item, such as the use of inventories to accumulate costs. Sec. 1.446-1(a)(1), Income Tax Regs. The use of any method of accounting or any change in method of accounting is subject to the mandate that the method used must clearly reflect income. Sec. 446(b). A taxpayer who changes the method of accounting from the method by which he regularly keeps his books and records and computes his income must secure the consent of the Secretary of the Treasury prior to the use of the new method. Sec. 446(e).

Income from long-term contracts may be reported under the percentage of completion method or the completed contract method of accounting or any other method if the method chosen clearly reflects income and is applied consistently to all long-term contracts within the same trade or business. Sec. 1.451-3(a)(1), Income Tax Regs.[4] The regulations applicable in the instant case expressly permit certain manufacturers to use the completed contract method of accounting with respect to long-term contracts

---

[4] The Commissioner has recently issued final regulations, effective for taxable years beginning after December 31, 1982, that permit taxpayers using the completed contract method of accounting to value the costs associated with long-term contracts under inventory methods of accounting, including the LIFO method. These regulations, however, restrict the manner in which an inventory method can be used by requiring it to be applied to value the costs of materials associated with long-term contracts in the year in which materials are purchased for a particular long-term contract or are dedicated to a particular long-term contract and not in the year in which the contract is completed. T.D. 8067, 1986-6 I.R.B. 5 (December 30, 1985).

BEST COPY AVAILABLE

which are defined as building, installation, construction, or manufacturing contracts that are not completed in the taxable year in which they are entered. Sec. 1.451-3(b)(1)(i), Income Tax Regs. The long-term contract must involve either the manufacture of unique items of a type which is not normally carried in the finished goods inventory of the taxpayer, or items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract). Sec. 1.451-3(b)(1)(ii), Income Tax Regs.

Under the completed contract method of accounting used by petitioner during its entire existence, the taxpayer includes the gross contract price of a long-term contract in gross income in the year in which the contract is completed. All costs which are properly allocable to the long-term contract are deducted from gross income for the taxable year in which the contract is completed, including material and supplies charged to the contract but remaining on hand at the time of completion. Sec. 1.451-3(d)(1), Income Tax Regs. This method is particularly appropriate to a taxpayer engaged in the business of performing contracts where the contracts overlap accounting periods and where the ultimate profit or loss from the contract cannot be ascertained until the contract is completed. Fort Pitt Bridge Works v. Commissioner, 24 B.T.A. 626 (1931), revd. on other grounds 92 F.2d 825 (3d Cir. 1937). Petitioner's business of manufacturing individualized pools that are not carried as

BEST COPY AVAILABLE

finished goods inventory and whose construction sometimes overlaps accounting periods lends itself particularly well to the completed contract method of accounting.

The Commissioner is authorized to require that taxpayers utilize inventory accounts in order that the accounting method may clearly reflect income. Sec. 471. In this instance, however, respondent argues that the combination of the completed contract method for the reporting of income and the LIFO method of valuing inventories to determine the cost of goods does not clearly reflect income. The use of inventories to determine costs arises from section 1.471-1, Income Tax Regs., which provides that inventories are necessary in order to reflect taxable income correctly in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Inventories are also required when merchandise is produced in accordance with customer specifications. See Frank G. Wikstrom & Sons, Inc. v. Commissioner, 20 T.C. 359 (1953). Inventories include both raw materials and work-in-process. Sec. 1.446-1(a)(4)(i), Income Tax Regs. In this case, the production and sale of merchandise is the source of Shasta's income; further, the merchandise is produced in accordance with customer specifications, which factors lead to the conclusion that the use of inventories by Shasta is mandated by sections 446 and 471.

This Court has held that it is permissible for a manufacturer using the completed contract method of accounting to determine the costs attributable to its long-term contracts by

BEST COPY AVAILABLE

the use of inventories, including the LIFO inventory method. RECO Industries, Inc. v. Commissioner, supra; Peninsula Steel Products & Equipment Co. v. Commissioner, supra. The Claims Court disagreed with Peninsula Steel Products & Equipment Co. and adopted the arguments made in this case by respondent, holding that the use of inventories (valued either by the FIFO or the LIFO method) was not compatible with an accounting system which reported income using the completed contract method. Spang Industries, Inc. v. United States, supra. The Claims Court was, however, recently reversed by the Federal Circuit which found that the trial court's conclusion that inventories had not been used by the taxpayer prior to the taxable years at issue was clearly erroneous. Spang Industries, Inc. v. United States, 791 F.2d at 910 (Fed. Cir. 1986). The Federal Circuit also quoted, at length and with approval, our analysis of the law in this area as set forth in Peninsula Steel Products & Equipment Co. v. Commissioner, supra and RECO Industries v. Commissioner, supra.

Respondent's contentions as to the incompatibility of LIFO inventory accounting and the completed contract differ only in minor detail from the arguments presented to us and found to be unpersuasive in RECO Industries, Inc. and Peninsula Steel Products & Equipment Co. The arguments also parallel those made before the Claims Court that were emphatically rejected by the Federal Circuit. Spang Industries, Inc. v. United States, supra. We can see no significant differences between the factual

BEST COPY AVAILABLE

circumstances present in Peninsula Steel, RECO Industries, and Spang and the facts present in this case. Further, no legal arguments have been presented that would persuade us to deviate from our view that the use of the LIFO method of valuing inventories and the use of the completed contract method of reporting income are neither inconsistent nor prohibited.

Respondent asks us to overrule or distinguish our recent opinions on the grounds that the requirement that deferral of the deduction of costs "properly allocable to a long-term contract" under sections 1.451-3(a) and 1.451-3(d), Income Tax Regs., prohibits the use of inventories in accumulating contract costs and mandates the specific identification of costs. The provision relied upon by respondent serves as no more than a timing requirement and not a direction as to the manner in which contract costs should be accumulated. RECO Industries, Inc. v. Commissioner, supra at 922. The regulations simply do not contain a prohibition against the use of inventories to determine the amount of deductible costs to be applied against the gross income resulting from a long-term contract reported under the completed contract method. Peninsula Steel Products & Equipment Co. v. Commissioner, supra at 1050-1051.

Shasta values its warehoused materials and work-in-process inventories by use of the LIFO method.[5] The theory of the LIFO

---

[5] The dollar value method of pricing LIFO inventories used by petitioner is authorized by sec. 1.472-8, Income Tax Regs. As respondent has conceded that the pricing method is proper if the use of inventories in this context is found to be correct, we (footnote continued)

BEST COPY AVAILABLE

method is generally that the determination of income may be more accurate if current costs are matched with current revenues, thereby eliminating any inflation-induced profit. See Peninsula Steel Products & Equipment Co. v. Commissioner, supra at 1054; Fox Chevrolet, Inc. v. Commissioner, 76 T.C. 708, 723 (1981). The LIFO method utilized by petitioner to value its inventory pursuant to its election filed with the Commissioner is expressly authorized by section 472. As this statute expressly grants taxpayers the right to elect the LIFO method for purposes of valuation of their inventory of goods, respondent's discretion as to an initial election of LIFO is clearly more circumscribed than would generally be the case as to changes of accounting method.[6] W.C. & A.N. Miller Development Co. v. Commissioner, 81 T.C. 619 (1983).

Respondent contends that the use of LIFO inventory and the consequent LIFO reserve permits Shasta to accelerate costs allocable to work-in-process to the current taxable year and to

---

(footnote continued from previous page)
need not discuss further the mechanics of the pricing of the inventory.

6 From its inception, petitioner consistently used inventories in the determination of the cost of goods sold. Under section 472(a), Shasta, as a taxpayer required or permitted to maintain inventories, had the right to value those inventories at LIFO. The filing of its Form 970 with its tax return for the taxable year 1979 was all that was necessary to authorize Shasta to use LIFO; the change to LIFO was not a change in the method of accounting that required the consent of the Commissioner. Spang Industries, Inc. v. United States, 791 F.2d 906, 911 (Fed. Cir. 1986), reversing 6 Cl. Ct. 38 (1984); John Wanamaker Philadelphia, Inc. v. United States, 359 F.2d 437, 440 (Ct. Cl. 1966).

BEST COPY AVAILABLE

apply those costs as costs of goods sold against the income reported for contracts completed during the current year, the income from which has been deferred from previous taxable years. The net result, argues the respondent, is a mismatch of expenses and income that does not clearly reflect income. We continue to reject this position as a misconception of the purpose of the LIFO reserve account. As we stated in Peninsula Steel Products & Equipment Co. v. Commissioner, supra:

> The determination of the value to be placed upon an inventory has no relation to the principle or theory affecting the determination of when income is deemed to be received and expenses deemed, incurred. As such, the additions to the LIFO reserve account do not amount to additional deductions for inventories included in cost of good sold, but rather, represent the difference between the valuation of ending inventories using most recent costs (FIFO) and earliest costs (LIFO). Stated another way, the additions to the LIFO reserve account represent the difference in the deduction for costs of completed contracts when the most recent costs are assigned to the completed contracts under LIFO as opposed to the assignment of the earliest costs on a FIFO basis. [78 T.C. at 1057; citations omitted.]

The use of LIFO reserves is no more or less than a method for assigning the value of the items used in the construction of swimming pools for which the contracts have been or will be completed. It does not represent any additional materials used but merely assigns a cost to the materials used on the basis of last-in/first-out in an attempt to match the current cost of the materials to the amount currently reported as income from completed contracts. In the case of LIFO reserves for work-in-process, the reserve account serves only as a method of valuing costs which are to be deducted in the future as costs of goods

BEST COPY AVAILABLE

and does not represent current deductions related to contracts for which the income has not yet been reported. The LIFO reserve account only has an impact on the cost of goods sold when the costs are transferred as each contract is completed, as the reserve account adjusts a portion of the costs properly allocable to each completed contract from FIFO to LIFO inventory accounting.

Respondent urges us to distinguish the facts and circumstances of this case from those found in RECO Industries, Inc. and Peninsula Steel Products & Equipment Co. Specifically, respondent contends that specific identification of costs is not only possible but more suited to petitioner's form of operation than the LIFO inventory method.[7] The parties stipulated, however, that most of the raw materials used for the construction of these pools was obtained from Shasta's warehouses and were not, as urged by respondent, materials ordered for specific jobs. Further, the fungible nature of steel and plaster, two of the major components of the pools, would make it extremely difficult for petitioner to specifically identify these major costs. Respondent's argument for specific identification in preference to the LIFO inventory method consistently used by the taxpayer is not supported by any statutory or regulatory requirement and is

---

[7] Although respondent has conceded that the use of LIFO inventory as to warehoused materials is proper, he wishes to require that petitioner use specific identification to identify the costs of those materials as they are transferred to work-in-process. No explanation has been offered as to how petitioner is to avoid difficulties with proper reporting of income due to the adjustments necessary with respect to the intracompany transfer.

BEST COPY AVAILABLE

not in accord with the practical realities of the types and amounts of materials used in the construction of pools by petitioner. It is a well-established principle that the Commissioner cannot require a taxpayer to change from an accounting method that clearly reflects income merely because the Commissioner considers an alternate method to more clearly reflect income. Molsen v. Commissioner, 85 T.C. 485, 498 (1985).

Respondent also contends that, unlike RECO Industries, Inc. and Peninsula Steel Products & Equipment Co., the items built by the taxpayer are not merchandise but are improvements to real property that may not be inventoried. Real estate and improvements to real estate are not normally considered to be "merchandise" for the purpose of determining whether the use of inventories is permitted to the taxpayer. W.C. & A.N. Miller Development Co. v. Commissioner, supra at 628-630. In this case, however, Shasta is maintaining inventory in the form of materials and work-in-process, not in the form of real estate to which it holds title nor in the form of improvements to its own real estate. Respondent asks us to find that the swimming pools that are in the process of installation become fixtures to the land before transfer of title to the customer, citing Fish v. Valley National Bank of Phoenix, 64 Ariz. 164, 167 P.2d 107 (1946). The swimming pools at issue are undoubtedly large and relatively difficult to remove. In size and immovability, however, they are practically impossible to differentiate from the large steel tanks in RECO Industries, Inc. or the large precipitators used in

BEST COPY AVAILABLE

industrial air pollution control systems that were at issue in Peninsula Steel Products & Equipment Co. We cannot, and do not, find that the facts and circumstances warrant a finding that the pools at issue are not "merchandise" within the meaning of section 1.471-1, Income Tax Regs.

Petitioner's accountant testified, without contradiction, that the combination of income recognition based on the completed contract method and allocation of work-in-process costs based on LIFO inventory meets generally accepted accounting principles. The completed contract method and the LIFO method of identifying inventory costs have been consistently applied by Shasta. In general, an accounting method that conforms with generally accepted accounting principles that is consistently applied will be regarded as clearly reflecting income for tax purposes. Sec. 1.446-1(a)(2), Income Tax Regs. Conformity with generally accepted accounting principles is not sufficient, however, if the result is a failure to comply with the Code or the regulations. In that case, the accounting method would fail to clearly reflect income and would not be permitted for income tax purposes. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540-544 (1979). No such failure to comply with the Code or regulations has been found. Further, the use of the LIFO method for valuing work-in-process inventories has clearly not distorted the reporting of income by petitioner as its use when compared to the use of FIFO inventory valuation (normally even less favorable than the specific identification method used by respondent) has affected

BEST COPY AVAILABLE

the gross profit percentage over the three taxable years of its use by less than two-tenths of one percent. We find that petitioner's accounting practices are in accordance with generally accepted accounting principles, that they are not prohibited by any portion of the Code or regulations, and that they also clearly reflect income. See RECO Industries, Inc. v. Commissioner, supra at 925-926.

A final point raised by respondent is that, even if the use of inventories are appropriate with completed contract reporting of income, Shasta did not own all of the items in its work-in-process inventory, either because petitioner never had title to the items or because title vested in the customer during the installation process. A number of the materials used were purchased for and delivered to specific sites, but were clearly included within the general category of materials for which the contract established title. Merchandise may be included in inventory only if title is vested in the taxpayer. Sec. 1.471-1, Income Tax Regs. In determining the passage of title, State law controls. Under Arizona law, the intent of the parties controls. Williams v. Long, 1 Ariz. App. 330, 402 P.2d 1006 (1965). The intent of the parties, when the contractual arrangements are viewed in toto, is that title to the pools does not pass until the customer has completed payment. Although the risk of loss was assigned to the customer under the Sales Contract, the contractual provisions did not pass title to the customer but merely made the customer responsible for theft or vandalism once

BEST COPY AVAILABLE

the goods were no longer in the possession of Shasta. Shasta retained title and reserved the right to remove the concrete, steel, and equipment, under the Layout Acceptance Form, until payment was completed. Risk of loss is but one factor to consider in determining the intent of the parties as to when title passes. People v. Seymour, 54 Cal. App.2d 266, 128 P.2d 726 (1942). Upon the completion of the schedule of payments established under the Sales Contract, title was effectively transferred, but not before that time. Completion of payment also, of course, triggered reporting of the entire amount of income reduced by the cost of goods sold with respect to that contract.

We find that the use by petitioner of LIFO inventory for both raw materials and work-in-process together with the completed contract method of accounting for the taxable year 1981 was proper. RECO Industries, Inc. v. Commissioner, supra; Peninsula Steel Products & Equipment Co. v. Commissioner, supra.

Decision will be entered for the petitioner.

BEST COPY AVAILABLE

COMPLETED
AUG 19 1986
Ju 11.7/2:1986-378
MF211

T. C. Memo. 1986-378

ORIGINAL

UNITED STATES TAX COURT

DALENE T. BUBECK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34900-83. Filed August 14, 1986.

Kevin O. O'Brien, for the petitioner.

James B. Martin, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined a deficiency in petitioner's income tax for 1981 in the amount of $652.00 and an addition to tax under section 6653(a)[1] in the amount of $32.60. There are two issues for decision: (1) Whether respondent correctly determined the tip income received by petitioner during

[1] All section references are to the Internal Revenue Code of 1954, in effect during the year in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

BEST COPY AVAILABLE

1981; and (2) whether petitioner is liable for the addition to tax under section 6653(a) for negligence or the intentional disregard of rules and regulations.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein by reference.

Petitioner resided during 1981 and at the time of filing her petition in Denver, Colorado. In 1981 she worked as a waitress at a restaurant called Baby Doe's Matchless Mining (Baby Doe's). She began working at Baby Doe's in February and worked through June and again from September through December. She worked a total of 849.5 hours, 123 as a cocktail server, 707.25 as a food server on both day and night shifts, and 19.25 at employee meetings. The hours worked as a food server included 55 hours during which petitioner trained new employees. Under Baby Doe's policy, a trainer was entitled to all tips earned by the trainer or her trainee.

Food servers at Baby Doe's worked from one of several stations at the restaurant. They were rotated from station to station, with a complete rotation taking approximately two months. It was Baby Doe's policy to rotate the food servers impartially, fairly, and evenly.

BEST COPY AVAILABLE

Petitioner was paid biweekly. Each salary check reflected the hourly wages for the two-week period as well as the amount of tip income she had reported to Baby Doe's for such period.[2] It was petitioner's responsibility to keep account of her tip income and report it to Baby Doe's on a biweekly basis. During 1981, petitioner reported to Baby Doe's tip income totaling $831.95.

During her first period of employment, from February through June, petitioner recorded her tips daily in a notebook kept in her car. From September through December she recorded the tips on separate sheets of paper, which also were kept in her car. After each period of employment she destroyed the records.

Respondent determined the tip income of petitioner by using the charge sales records of the restaurant. Using a 28-day sample of credit card receipts reflecting tips, which sample was taken randomly from all of Baby Doe's credit card receipts in 1981, respondent determined that on the average day shift food servers received tips of $4.74 per hour, night shift food servers received tips of $5.85 per hour, and cocktail servers received

---

[2] The tip income was included in petitioner's gross pay for the period solely for the purpose of determining the amount of tax to be withheld from the wages.

BEST COPY AVAILABLE

tips of $4.87 per hour.[3] With these averages, respondent determined that petitioner had unreported tip income of $3,512.64 as follows:

Category Worked	Hours	Rate	Total
Day Shift Food Server	353.00[4]	$ 4.74	$1,673.22
Night Shift Food Server	354.25	5.85	2,072.36
Cocktail Server	123.00	4.87	599.01
Total Tip Income			$4,344.59
Tip Income Reported to Baby Doe's			831.95
Unreported Tip Income			$3,512.64

---

[3] Respondent's computation is as follows:

	Day Shift Food Server	Night Shift Food Server	Cocktail Server
Baby Doe's Sales Allocated to Each Category	$494,505.57	$1,864,206.17	$234,319.22
Less Stiffs and Other Reduction Factors	x .90	x .90	x .80
	$445,055.01	$1,677,785.55	$187,455.38
Times the Tip Percentage	x .1476	x .1456	x .1725
	$ 65,690.12	$ 244,285.58	$ 32,336.05
Less Tipouts			
Food Servers 15% to Busboys	(9,853.52)	(36,642.84)	
Food Servers 10% to Bartenders	(6,569.01)	(24,428.56)	
Cocktail Servers 10% to Bartenders			(3,233.61)
	$ 49,267.59	$ 183,214.18	$ 29,102.44
Divided by Total Hours Worked In Each Category	10,403.25	31,317.75	5,974.00
Tips Per Hour Per Category	$ 4.74	$ 5.85	$ 4.87

[4] Petitioners' 55 hours of training other employees were included in her total day shift food server hours.

BEST COPY AVAILABLE

OPINION

(1) Tip Income

Tips are includable in gross income since they constitute compensation for services rendered. Section 61(a); section 1.61-2(a)(1), Income Tax Regs.; Killoran v. Commissioner, 709 F.2d 31 (9th Cir. 1983), affg. T.C. Memo. 1981-659; Roberts v. Commissioner, 176 F.2d 221 (9th Cir. 1949), affg. 10 T.C. 581 (1948); Schroeder v. Commissioner, 40 T.C. 30, 33 (1963).

All taxpayers are required to keep sufficient records to enable respondent to determine their correct tax liability. Section 6001. When a taxpayer receives income from tips, the required records include an accurate and contemporaneous diary of such income. Section 1.6001-1(a), Income Tax Regs. Section 6053 and the regulations issued thereunder, also require the employee to report the correct amount of the tips to their employer.

In this case petitioner temporarily kept records of her tip income, but she was unable to produce them for respondent's inspection and at trial because she had destroyed them. Respondent, therefore, is authorized by section 446 to compute petitioner's tip income by any method which, in his opinion, clearly reflects such income. Meneguzzo v. Commissioner, 43 T.C. 824, 831 (1965); Sutherland v. Commissioner, 32 T.C. 862 (1959). Petitioner has the burden of proving that his determination is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

BEST COPY AVAILABLE

Petitioner disputes respondent's determination on the following grounds: (1) She had a poor attitude towards her job and, consequently, experienced a stiff rate higher than that used by respondent; (2) she was assigned initially to stations that were not very busy; (3) she worked many day shifts, during which business was slow; (4) respondent used an erroneously low tip-out rate for busboys; (5) during the hours she served as a trainer, she let the trainee keep all the tips; and (6) of her hours as a food server, she only worked 123 hours on the night shift, not the 354.25 hours used by respondent in his calculations.

With respect to all of the above grounds except the fifth and the sixth, petitioner has failed either to establish the truth of the assertion or to demonstrate its effect upon respondent's determination. With respect to the fifth ground, however, we are satisfied from her testimony that while serving as a trainer petitioner permitted the trainee to keep all the tips and, as a result, petitioner received no tip income during the 55 hours of training. We are also satisfied that she only worked 123 hours on the night shift. Therefore, the unreported tip income as determined by respondent will be reduced accordingly.

While we recognize that petitioner may have earned less in tips than the averages computed by respondent, it was petitioner's responsibility to keep and produce at trial records of such tips or to show that respondent's calculations are not

BEST COPY AVAILABLE

substantially correct. Petitioner having failed to do either, respondent's determination has to be sustained, except as provided above.

(2) Addition to Tax

Petitioner admittedly failed to make and retain an accurate record of her tip income as required by section 6001 and the record contains no evidence which tends to justify her failure to do so. Therefore, respondent's determination with respect to the addition to tax provided by section 6653(a) is sustained. Meneguzzo v. Commissioner, 43 T.C. 824, 836 (1965).

Decision will be entered under Rule 155.

BEST COPY AVAILABLE